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The Economic Realities of a "Security": Is There a More Meaningful Formula?

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The existence of a "security" is of vital importance in determining whether the federal and state securities laws will apply to certain transactions. The continually widening scope of such laws has prompted Professor Coffey first to discuss briefly the definition sections of the federal statute and then to examine the basic formula propounded by the Supreme Court for determining the existence of a security. After submitting that the twenty-year-old formula might be lacking in some areas, the author proposes and then thoroughly discusses his own theory which is based upon the essential economic considerations underlying the "security" concept. Professor Coffey concludes with a discussion of statutory construction in light of the formulas proposed by the courts and the definition sections of the statutes.

I. INTRODUCTION

A. *The Problem and Its Importance*

RECENT YEARS have witnessed a substantial increase in the number of statutory roads to redress available to the disenchanted purchaser of a "security." On the frontiers of this expansion of remedies is the increased use of SEC Rule 10b-5[1] as the basis of fraud-type actions brought by securities buyers. Despite persuasive arguments to the contrary,[2] buyers have been rather successful in circumventing the restrictions[3] imposed on actions under section 12(2) of the Securities Act of 1933[4]

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1 17 C.F.R. § 240.10b-5 (1964), promulgated under the Securities Exchange Act of 1934, § 10(b), 48 Stat. 891, 15 U.S.C. § 78j(b) (1964) [hereinafter cited as Exchange Act].

2 3 LOSS, SECURITIES REGULATION 1778-97 (2d ed. 1961, Supp. 1962).

3 *Id.* at 1779-80. Such restrictions include a short statute of limitations, relief limited to rescission while the plaintiff is still in possession of the purchased securities, and the possibility that security for costs and reasonable attorneys' fees may be required.

4 48 Stat. 84, as amended, 15 U.S.C. § 77*l*(2) (1964) [hereinafter cited as Securities Act].

simply by pursuing a cause of action under Rule 10b-5[5] or even under section 17(a) of the Securities Act.[6]

While adding to the number of remedial arrows in the quiver of the securities purchaser, the courts and administrative agencies have also increased the range of those arrows by evolving what has been termed the "Expanding 'Securities' Concept."[7] While the proposition that the "security" concept itself is expanding may be debated, it is unquestionably true that the last half decade has seen many devices and transactions brought within the pale of the state and federal securities laws,[8] all to the great chagrin of many practicing attorneys. The inclusion of an ever-widening variety of transactions within the definition of "security," coupled with the tendency of the courts to give buyers a wider choice of statutory remedies, has substantially magnified the impact of the securities laws on the business community.[9] At the very least, the prospect that these statutes might continue to grow "at both ends" (in remedy as well as in definitional coverage)[10] should be reason for a thoughtful second look at some of the basic propositions and considerations underlying the securities laws.[11]

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[5] *E.g.*, Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Rustic v. Werblin, CCH FED. SEC. L. REP. ¶ 91637 (S.D.N.Y. Feb. 28, 1966) (recognizing fraud-type actions by buyer based on SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964), the Securities Act, *and state law* under pendent jurisdiction).

[6] *E.g.*, Pfeffer v. Cressaty, 223 F. Supp. 756 (S.D.N.Y. 1963) (Securities Act § 17(a), 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q(a) (1964); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964)), wherein the plaintiff was permitted to pursue an action for damages while still in possession of the purchased securities. The reason given for finding an independent cause of action under § 17(a) was that in such an action, "plaintiff would not have the advantage of the unusual rule as to burden of proof [defendant has the burden of proving defense of innocence] created by Section 12." Pfeffer v. Cressaty, *supra* at 758; *cf.* Belhumeur v. Dawson, 229 F. Supp. 78 (D. Mont. 1964).

[7] See Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728 (1961).

[8] See generally 1 LOSS, *op. cit. supra* note 2, at 455-512. The question of which devices and transactions come within the purview of the state and federal definitions of "security" has been actively litigated, and there have been many reported decisions in this area since the 1962 Supplement to Professor Loss' treatise.

[9] Indeed, perhaps the day is not far hence when it will be said of the securities laws — as it has been similarly said of heaven, the Internal Revenue Code, and the antitrust statutes — that "not a sparrow falls without the securities laws nodding their assent."

[10] The jurisdictional requirements of the federal securities laws are also being relaxed. See, *e.g.*, Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964) (intrastate telephone call sufficient jurisdictional basis for applying Securities Act § 5, 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e (1964)). Perhaps the federal securities laws should be described as growing at both ends *and in the middle.*

[11] While the task of determining whether a particular device or agreement is a security seems a humble one, one blue sky law administrator has recently said that, of all the securities conundrums, "ascertaining whether a security is involved in a particular transaction can be the most difficult problem an attorney faces." Newton, *A Look at*

Having noted charily that the widening vistas of remedy tend to broaden the effects of extending the definitional coverage of the securities laws, this discussion now focuses on the latter problem, *i.e.*, the issues and analysis involved in determining what transactions should come within the definition of a "security."

B. Framework and Structure of Analysis

The starting points for an examination of the "security" concept are the definition sections of the federal statutes[12] and of the state blue sky laws.[13] These definition statutes typically include a list of fairly specific and readily identifiable types of devices and arrangements,[14] along with a group of more general classifications which tend to be less susceptible of any single meaning.[15] The courts, counsel, and administrative agencies have long wrestled with both the specific and the general elements of the definition, struggling to explicate the essential characteristics of the "security" concept. It is within the framework of the more recent cases which

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the Montana Securities Act and Its Relation to the Federal Securities Act, 26 MONT. L. REV. 31, 35 (1964).

12 Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(2) (1964); Exchange Act § 3(a)(10), 48 Stat. 882 (1934), as amended, 15 U.S.C. § 78c(a)(10) (1964); Public Utility Holding Company Act of 1935, § 2(a)(16), 49 Stat. 803, as amended, 15 U.S.C. § 79b(a)(16) (1964); Investment Company Act of 1940, § 2(a)(35), 54 Stat. 789, as amended, 15 U.S.C. § 80a-2(a)(35) (1964); Investment Advisers Act of 1940, § 202(a)(17), 54 Stat. 847, as amended, 15 U.S.C. § 80b-2(a)(17) (1964). The Trust Indenture Act of 1939, § 303(1), 53 Stat. 1151, as amended, 15 U.S.C. § 77ccc(1) (1964), adopts the definition of Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(2) (1964). There are some minor and some major differences in these definitions, and the discrepancies will be noted as they become critical to the analysis in the text. Recently promulgated SEC Rule 3a11-1, 17 C.F.R. § 240.3a11-1 (Supp. 1966), defining "equity security," will have some impact on our subsequent analysis, as will the exemptions found in Securities Act §§ 3-4, 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c-d (1964).

13 As Professor Loss has indicated, some care must be exercised to note differences in the specific wording of the various state and federal statutes. 1 LOSS, *op. cit. supra* note 2, at 456. However, the state courts especially have exhibited a remarkable elasticity in following the decisions under the federal acts and the laws of other states. They appear favorably disposed to discount the significance of the categories listed in the statutory definition in favor of a more pervasive, and perhaps more meaningful, concept. This problem will be explored at greater length later in the article.

The definition contained in the UNIFORM SECURITIES ACT § 401 *l*, 1 BLUE SKY L. REP. ¶ 4931 (1958), is very similar to that in the Federal Securities Act. The Uniform Act has been adopted substantially or in modified form in twenty-one states, the District of Columbia, and Puerto Rico. 1 BLUE SKY L. REP. ¶ 4901 (1965).

14 *E.g.*, "any note, stock . . . bond, [or] debenture." Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1964).

15 *E.g.*, "certificate of interest or participation in any profit-sharing agreement . . . transferable shares, investment contract . . . or, in general, any interest or instrument commonly known as a 'security' . . . ." *Ibid.*

have construed and applied the definitional provisions of the state and federal securities laws — in their general[16] and specific aspects — that this article will conduct its analysis.[17] The primary goal of this article is thus to formulate, from a consideration of a number of recent opinions involving a variety of devices and arrangements,[18] a set of analytical tests and guidelines which might be used to determine whether particular transactions involve securities and are hence the proper subjects of the special regulatory features of the state and federal securities laws.

First, the basic structure and protections of the securities laws will be examined in an effort to state, in the most general terms, the fundamental considerations which should underlie any examination of the distinguishing features of a security.[19] This is followed by a discussion of a revered formula which traditionally has been thought of as accurately setting forth the specific indicia of a security.[20] Then, with some trepidation, there is suggested a more complete and reliable shorthand description of the essential economic realities underlying the "security" concept.[21] Each element of the proposed definition is discussed at some length,[22] and particular attention is paid to the problems created when courts and administrative agencies become too enamored of neat formulas handed down from prior opinions and fail to focus on the essential economic considerations relevant to identifying a security. Also explored are

[16] Perhaps the most enlightening attempts to enunciate the true nature of a security are found in cases applying the general provisions of the definition sections, which must be invoked whenever novel devices or transactions are the subjects of litigation. Certainly the broad provisions should stimulate the deepest thought on the part of practitioners. "The definition [of 'security'] expressly includes many of the more orthodox types of securities, and, though patent, even these are sometimes inadvertently 'missed' (for example, preorganization subscriptions). The definition contains several categories, however, which can be extremely troublesome, and understandably 'missed.'" Newton, *supra* note 11, at 35.

[17] It will be necessary, however, to consider certain of the older cases whose holdings (but not necessarily whose reasoning) will serve as the bedrock of this discussion.

[18] Of primary concern will be such devices as: promissory notes, cooperative apartments, organization memberships, franchises, coin investment agreements, preincorporation arrangements, interests in developmental property, interests in productive property accompanied by management agreements, limited partnership interests, retail marketing and financing techniques, and a variety of other novel but thought-provoking transactions. Some notable *lacunae* in this article are the areas of commingled trusts, equity-insurance arrangements, managing agency accounts, and mineral interests, although now and then one may catch the scent of crude as the landmark case on oil leases, SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943), is referred to.

[19] See text accompanying notes 25-32 *infra.*

[20] See text accompanying notes 33-46 *infra.*

[21] See text accompanying note 47 *infra.*

[22] See text accompanying notes 48-159 *infra.*

the distortions introduced by a rigidly literal approach to statutory interpretation or by an excessive concern for deceptive rules of construction.[23] Finally, the issues peculiar to isolated and private transactions are discussed, and possible solutions to some rather difficult problems of policy and statutory construction are indicated.[24]

II. ESSENTIAL CHARACTERISTICS OF A "SECURITY": STATUTES, FORMULAS, AND DECISIONS

A. General Conclusions Derived From Statutory Structure

The state and federal securities laws contain two basic levels of protection. First, they provide for the full disclosure[25] of registration or state administrative approval[26] whenever the security involved is not covered by certain exemptive provisions.[27] Second, even if the exemptive provisions apply so that registration or state approval are not required, distribution and trading ordinarily remain subject to several anti-fraud and anti-half-truth provisions.[28] Generally speaking, the anti-fraud statutes relax the procedural and substantive conditions of relief which are characteristic of the common law and equitable fraud actions.[29] Moreover, they usually carry criminal penalties for their violation.[30] From these simple observations two important sets of conclusions can be drawn:

(1) The considerations involved in determining whether a particular device or transaction is a security are not coextensive with the considerations used to determine whether full disclosure (by way

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23 See text accompanying notes 160-83 *infra.*

24 See text accompanying notes 184-204 *infra.*

25 Securities Act §§ 5-7, 8, 10, 48 Stat. 77, 79, 81 (1933), as amended, 15 U.S.C. §§77e-g, 77h, 77j (1964).

26 See, *e.g.,* in the area of state securities regulation, UNIFORM SECURITIES ACT § 304(c), 1 BLUE SKY L. REP. ¶ 4924 (1958).

27 Securities Act §§ 3-4, 48 Stat. 75 (1933), as amended, 15 U.S.C. § 77c-d (1964); UNIFORM SECURITIES ACT § 402, 1 BLUE SKY L. REP. ¶ 4932 (1958).

28 See Securities Act §§ 12(2), 17(a), 48 Stat. 84 (1933), as amended, 15 U.S.C. §§ 77*l*(2), 77q(a) (1964); Exchange Act §§ 15(c)(1)-(2), 48 Stat. 895 (1934), as amended, 15 U.S.C. §§ 78*o*(c)(1)-(2) (1964); UNIFORM SECURITIES ACT §§ 101, 410(a)(2), 1 BLUE SKY L. REP. ¶¶ 4902, 4940 (1958); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964). It is also probably true that the anti-fraud provisions apply to those transactions which the SEC has exempted in one way or another from registration. See, *e.g.,* regarding employee benefit plans, Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans,* 29 LAW & CONTEMP. PROB. 795, 808 n.42, 813-14 (1964). See also SEC Rule 133, 17 C.F.R. § 230.133 (1964), extending a kind of exemption to certain financial reorganizations.

29 See 3 LOSS, *op. cit. supra* note 2, at 1421-44, 1763-97.

30 Securities Act § 24, 48 Stat. 87 (1933), 15 U.S.C. § 77x (1964); Exchange Act § 32, 48 Stat. 904 (1934), as amended, 15 U.S.C. § 77ff (1964).

of registration) or administrative approval should be required. This is evident because the statutes are written so that the residual but substantial protection of the anti-fraud provisions persists notwithstanding the applicability of an exemption from registration or state approval. It is improper to equate the question of whether an arrangement constitutes a security with the question of whether the registration or approval philosophies should be invoked. To do so automatically excludes from the definition of "security" those transactions which possess enough troublesome characteristics to require liberal anti-fraud protection but which also involve enough balancing safeguards (or few enough additional worrisome characteristics) to eliminate the need for registration and state approval. For example, it cannot be said that an arrangement is not a security just because it is offered to only a few fully informed and sophisticated buyers so as to be exempt from registration or state approval.[31] By their structure, the securities laws clearly imply that the features of a transaction which dictate the requirement for registration or state approval are distinct from, and in addition to, the criteria employed in deciding the prior and more basic question of security *vel non*.[32]

(2) Although the securities laws are intended to cover more situations than those in which registration and state administrative approval are required, they cannot have been meant to embrace all

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[31] See Securities Act § 4(2), 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1964). The desirability of transferring some of the standards now used to determine the availability of exemptions (in particular, the number and character of the offerees) to the definition sections of the securities statutes will be discussed later in the article. Such standards would then be used in resolving the first and more basic question of whether a transaction is a security. See text accompanying notes 184-204 *infra*.

[32] There is a tendency on the part of courts and commentators, when discussing the criteria for determining whether an arrangement is a security, to state a test which is improperly couched in terms of whether the arrangement is one in which full disclosure (by way of registration) or state administrative approval should be required. For example, in Pasquesi, *supra* note 7, at 728, the writer begins his article on the definition of security by discussing the disclosure philosophy of the registration provisions of the Securities Act. See also Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied*, 382 U.S. 903 (1965), in which the court held that no security was involved within the meaning of the Federal Securities Act and the Illinois Blue Sky Law because, *inter alia*, "the protection of the full disclosure afforded by registration is not needed." *Id.* at 234, 204 N.E.2d at 809.

The proclivity to phrase the question of whether a particular transaction is a security in terms of whether the full disclosure of registration should be required has spawned some interesting comments on the security aspects of limited partnership interests. It seems to be the position of some that limited partnership interests should not be deemed securities at all when they are non-transferable and offered to a cozy little group of fully informed, though passive investors. See 1 LOSS, *op. cit. supra* note 2, at 504-06. Under the present statutory scheme, however, the number and knowledge of the offerees seem relevant only to the question of whether the sale is a private one and therefore exempt under Securities Act § 4(2), 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77d (1964).

transactions involving fraud or half-truths. The special prohibitions against misstatements and material omissions, together with specific procedures and remedies, constitute a general liberalization of common law fraud relief and are obviously meant to apply only when there are special policy justifications for invoking their protection.

Combining the preceding conclusions, the following proposition may be legitimately derived from an examination of statutory structure: A "security" is a transaction whose characteristics distinguish it from the generality of transactions so as to create a need for the special fraud procedures, protections, and remedies provided by the securities laws. This proposition may be rephrased in the form of a "master question" regarding the nature of a security: What characteristics or features of a transaction necessitate its being subject to the rather specialized anti-fraud protection afforded by the securities laws? The air has now been cleared by demonstrating that the inquiry made herein cannot be identified with the question of whether registration and state administrative approval should be required. Recognizing, therefore, that the characteristics sought constitute a certain minimum group of elements which are not necessarily sufficient to give rise to a requirement for full disclosure and approval, an examination of the specific characteristics contained in the judicially approved formula for identifying a security is in order.

B. *The Howey Formula*

In response to the "master question" posed in the preceding discussion, the Supreme Court of the United States, in *SEC v. W. J. Howey Co.*,[33] propounded the following formula: "A security[34] is a transaction . . . whereby [1] a person invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party."[35] This formula has

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[33] 328 U.S. 293 (1946).

[34] The *Howey* case involved the interpretation of the phrase "investment contract" in Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(2) (1964). For now, it will be assumed that the Court's enumeration of the essential characteristics of an investment contract applies to all the specific and general classifications contained in the definition sections of the various laws. See statutes cited notes 12-13 *supra*. The wisdom of applying an overriding "economic realities" test to all transactions which are claimed to be securities — even those which come within the literal meaning of words such as "notes," "stocks," and "bonds"—will be examined later. See text accompanying notes 160-83 *infra*.

[35] 328 U.S. at 298-99. Hereinafter, the formula quoted in the text shall be referred to as the "*Howey* formula" or the "*Howey* test."

been quoted and purportedly applied in a myriad of federal and state cases and administrative opinions.[36] It is true that a formula is an extremely helpful tool when used as a checklist or guideline for adjudication. However, the formula must be, in the first instance, the product of an accurate and complete analysis which will lead to its intelligent application in subsequent, but often differing, fact patterns.

Although the *Howey* opinion contains much enlightening discussion, it seems incomplete or misleading with respect to certain essential qualities of a security. These shortcomings are, not surprisingly, reflected in the *Howey* test itself. As a prelude to later analysis, attention is called to the following points which seem to render the *Howey* formula (to use the Court's own adjective) "unrealistic:"[37]

(1) The *Howey* test attenuates (or ignores) the risk of loss of the original value furnished by the purchaser.[38] This deficiency is aggravated by the summary and misleading treatment given to the reasoning of the two lower courts,[39] which stressed the fact that the buyer had received, in exchange for his initial value, tangible property with an intrinsic value not dependent on the success of any enterprise — a circumstance which bears directly on the buyer's risk of losing the value which he originally furnished.[40]

(2) The words "common enterprise" are particularly ambiguous, having a wide range of possible meanings,[41] and tend to fog

[36] United States v. Herr, 338 F.2d 607, 609-10 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1966); Roe v. United States, 287 F.2d 435, 438 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961); Blackwell v. Bentsen, 203 F.2d 690, 693 (5th Cir. 1953), *cert. denied*, 347 U.S. 925 (1954); SEC v. Orange Grove Tracts, 210 F. Supp. 81, 82 (E.D. Mass. 1962); Emery v. So-Soft, Inc., 199 N.E.2d 120, 123 (Ohio Ct. App. 1964).

[37] "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." 328 U.S. at 301.

[38] Throughout this article, the phrase "original value furnished by the purchaser" will often be referred to simply as "original value," "initial value," or "initial investment." These terms relate to the money, property, or services furnished by the alleged "buyer" to the alleged "seller" in the first step of the purported "security" transaction. The term "buyer" will be used to refer to the would-be purchaser of the purported security — the one who furnishes the initial value. "Seller" relates to the one who receives the initial value.

[39] SEC v. W. J. Howey Co., 60 F. Supp. 440, 442 (S.D. Fla.), *aff'd*, 151 F.2d 714, 717 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946).

[40] "We reject the suggestion of the Circuit Court . . . that [a security] . . . is *necessarily* missing where . . . the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole." 328 U.S. at 301. (Emphasis added.) This subject is worthy of closer scrutiny; the qualifying adverb "necessarily" probably saves the statement from being harmful dictum. See text accompanying notes 92-94 *infra*.

[41] Some possible "common enterprise" situations are those in which each of the par-

rather than to clarify the central issues involved in identifying a "security."

(3) Emphasis is placed on the inducement of future "profits." The criticism here is twofold. First, attention is focused on the promise of future profits and drawn away from the risk of immediate loss of initial investment. Second, the word "profits" presents some troublesome problems of interpretation.[42]

It is a major contention of this article that risk to initial investment, though not determinative, is the single most important economic characteristic which distinguishes a security from the universe of other transactions. It is further submitted that the courts and administrative bodies have placed too little emphasis on the danger of loss of original value, while placing too much emphasis on the inducement of future profits.[43] The numerous manifestations of risk to initial investment[44] have not been adequately recog-

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ticipants owns: (1) a percentage interest in the assets or entity of an enterprise, it being understood that he will receive a share of profits and that his original value shall bear a share of enterprise losses; (2) a claim against the enterprise, calling for return of his original value plus interest in scheduled payments, fixed or variable, related or unrelated to profits; (3) specific property employed or used by an enterprise, with each owner receiving a percentage share of the profits derived from the use of all such property — the percentage share being based on the ratio of the value of each owner's property to the total value of all such property; (4) the same facts as were listed in the third situation but with each owner receiving the net profits derived from his specific property; and (5) property not described in (1)-(4), the present value of which has been determined by taking into account the anticipated but unrealized success of the enterprise.

The foregoing are simply various ways in which money or property can be subjected to the risks of an enterprise. On the one extreme, the words "common enterprise" could be taken to convey the notion that the values furnished by investors must be subject to all the risks of an enterprise, pro rata, *e.g.*, by means of percentage shares in the enterprise assets or entity, where there is a pro rata division of the pooled gains and losses of all operations, giving some of the flavor of "common" stock. On the other hand, these words might simply be meant to describe situations in which the values furnished by investors are in some way subject to the risks of the *same enterprise*.

The adjective "common" also connotes plurality and poses the problem of whether there must be a minimum number of investors in the enterprise. The issues generated by the phrase are certainly fraught with fine distinctions which perhaps need not be drawn after more material but less complicated questions have been resolved.

42 The initial inquiry is whether the reference point of profitability is the buyer's initial investment or the overall operations of the risk enterprise. This question becomes critical when the buyer is led to expect a return over and above his initial investment, whether or not the enterprise has profits. A further question is whether a fixed rate or amount of return comes within the notion of "profits." Finally, do "profits" include unrealized appreciation or nonpecuniary benefits?

43 While the bulk of the decisions are probably correct on their facts, it is felt that their reasoning has been inaccurate or misleading, creating the danger of improper adjudication in the future.

44 See note 41 *supra*. However, the essential element of risk of loss of original value may be coming abruptly into its own. See Note, 50 CALIF. L. REV. 156 (1962); Note, 14 HASTINGS L.J. 181 (1962). Californians seem to have been jolted a bit by the

nized, and the much discussed element of expected "profits" has itself been misunderstood. In short, it is felt that the answer to the "master question" has not been fully and accurately answered by the *Howey* test or its underlying analysis.

The principal teaching of *Howey* is that, in the process of identifying a security, "form [is] . . . disregarded for substance and emphasis [is] . . . placed upon economic reality."[45] This short mandate yields two important lessons, one regarding statutory interpretation and the other concerning the kind of qualities which distinguish a security from the generality of transactions. Taking these topics in reverse order, the discussion now proceeds to a tentative statement of this author's own formula or checklist describing the *economic realities* underlying the "security" concept.[46]

C. *Statement of the Economic Realities of a "Security"*

The master question of this inquiry has been previously posited: What characteristics or features of a transaction necessitate its being subject to the rather specialized anti-fraud protection afforded by the securities laws? The *Howey* test has enjoyed the acceptance and approval of courts and agencies for twenty years. The function of this article is not to swim against the stream of past analysis, but rather to widen it here, narrow it there, and perhaps shift its course in various places. It is submitted that the following test states the essential economic characteristics which distinguish a security from the generality of transactions so as to create a need for the liberal procedures, protections, and remedies provided by the securities laws against fraud and half-truths.

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court's heavy emphasis on risk to initial investment in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

45 328 U.S. at 298.

46 In text accompanying note 47 *infra*, a formula will be offered stating the "economic realities" which are, it is contended, the essential characteristics of a "security." In text accompanying notes 48-159 *infra*, the proposed formula will be discussed in the context of a number of recent opinions in order to test the validity of its underlying analysis. The opinions occasionally manifest wayward reasoning, some of which seems to have been induced by the ambiguities of the *Howey* test; however, it will also appear that the adjudicators themselves have not been found wanting in their ability to introduce a variety of red herring. Text accompanying notes 160-83 *infra* will treat of the necessity of making the "economic realities" test a pervasive one, *i.e.*, one which would be controlling even when certain transactions come within the literal meaning of the readily identifiable classifications listed in the definitional statutes. Finally, text accompanying notes 184-204 *infra* focuses on some of the special problems created by isolated and private transactions and suggests some ways in which such transactions should be treated in the light of present statutory language and its implications.

A "security" is:

(1) A transaction[47] in which

(2) a person ("buyer") furnishes value ("initial value") to another ("seller"); and

(3) a portion of initial value is subjected to the risks of an enterprise, it being sufficient if —

(a) part of initial value is furnished for a proprietary interest in, or debt-holder claim against, the enterprise, or

(b) any property received by the buyer is committed to use by the enterprise, even though the buyer retains specific ownership of such property, or

(c) part of initial value is furnished for property whose present value is determined by taking into account the anticipated but unrealized success of the enterprise, even though the buyer has no legal relationship with the enterprise; and

(4) at the time of the transaction, the buyer is not familiar with the operations of the enterprise or does not receive the right to participate in the management of the enterprise; and

(5) the furnishing of initial value is induced by the seller's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above initial value, will accrue to the buyer as a result of the operation of the enterprise.

The foregoing statement reiterates the *Howey* test in some respects, but the essence of the "new look" is found particularly in the third and fourth paragraphs which highlight the troublesome prospect that the buyer's original value could dwindle because of the failure of an enterprise over which he exercises no control.

The phrase "common enterprise" has been abandoned because it implies that the buyer must receive a proprietary share in the enterprise with the understanding that his initial investment will bear its share of overall enterprise losses. As will be demonstrated, risk to initial investment can take several other forms. Moreover, there seems to be no requirement that there be any minimum number of buyers (or offerees), as the word "common" tends to imply.

Another general departure from the *Howey* formula is the wording "benefits of some kind, over and above initial value" instead of the term "profits." It will be seen that the expectation of fixed amounts or rates of return (related or unrelated to the profits reflected on the income statement of the enterprise), appreciation

[47] At text accompanying notes 184-204 *infra*, there is a discussion of the advisability of adding the following limitation after the word "transaction": "except an isolated transaction not involving an offering to the public."

in value, or even non-pecuniary benefits in excess of initial value should be sufficient to satisfy the profit inducement requirement.

The following discussion is an attempt to demonstrate the analytical approach by which the proposed "economic realities" test for identifying a security can be applied to the recent cases.

D. *Analysis of the "Economic Realities" Test in the Context of Recent Decisions*

(1) A Transaction.—As used in the test for identifying a security, the term "transaction" has a broad meaning indeed. It describes a concatenation of separate but related events, such as transfers of money and property, written promises, oral promises and representations, and even surrounding circumstances. All occurrences and events which can, in a broad sense, be properly considered as part of one bargain are welded together into one legally significant event for securities law purposes.

The ordinary transaction involves the transfer of money or property by the buyer in exchange for a written promise of some kind from the seller. However, a "transaction" may also consist of the transfer of initial value by the buyer, the buyer's receipt of an interest in specific real property, and the seller's representation that a developmental project nearby might cause an increase in the value of the buyer's interest.[48] A transfer of value by the buyer, the receipt of specific property in return, and the execution of an agreement giving the seller[49] or a third party[50] management control over the property may also comprise a single transaction.

48 SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943). The Court noted that "security" transactions are generally in documentary form but sometimes include surrounding circumstances. See Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961): "By its very nature, it is the *peculiar facts of the setting* which turn the offer from a mere sale of property into a sale of a security." *Id.* at 440. (Emphasis added.)

49 SEC v. W. J. Howey Co., 328 U.S. 293 (1946); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *petition for cert. dismissed per curiam*, 347 U.S. 925 (1954); SEC v. Great W. Land & Dev., Inc., CCH FED. SEC. L. REP. ¶ 91537 (D. Ariz. 1965) (Transfer Binder 1964-1966), *rev'd on other grounds*, 355 F.2d 918 (9th Cir. 1966) (buyer purchased an undivided beneficial interest in a specific parcel of land and agreed that the seller should have power to list and sell the real estate); Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (Dist. Ct. App. 1964), involving the sale of a growing grape crop together with an agreement that the seller would care for and market the grapes. The court considered the sale of the grapes together with the marketing and care agreement but held the combination did not constitute a "security." Op. Fla. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70653 (Dec. 14, 1964).

50 SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962). "The fact that . . . [the] third party [who takes management control of the property received by the buyer] may be legally distinct from the [seller of the property] . . . does not bring the activity outside the coverage of [the Securities Act] . . . ." *Id.* at 83.

The buyer's transfer of initial value has also been viewed in combination with: the seller's oral promises;[51] written and oral promises and representations by the seller;[52] the transfer of a franchise to the buyer, accompanied by the oral representations of the seller;[53] negotiable instruments plus the seller's oral representations and promises;[54] the transfer of a distributorship franchise to the buyer, followed by the buyer's purchase of tangible property for resale, coupled with an arrangement to have the seller do the reselling on a commission basis;[55] written "receipts" plus representations of the seller;[56] sales of consumer goods to the buyer for more than fair market value, accompanied by the oral and written representations and promises of the seller;[57] transfers of intangible property to the buyer together with oral and written agreements and representations regarding the seller's management of the intangibles;[58] or written

[51] Op. Nev. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70691 (Nov. 12, 1965) (oral partnership interests).

[52] SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961) (promissory notes and vague representations regarding buyer's future share in the success of the enterprise); People v. Smith, 180 Cal. App. 2d 420, 4 Cal. Rptr. 282 (Dist. Ct. App. 1960) (promissory notes and understandings that stock would be issued to replace notes). The notes would have been exempt under California law, but the court found that the whole transaction was an offer of stock. *Id.* at 425, 4 Cal. Rptr. at 285.

[53] Drug Management, Inc. v. Dart Drug Corp., CCH FED. SEC. L. REP. ¶ 91293 (D.D.C. 1963). The court, in holding that no "security" was involved, viewed a franchise agreement and the seller's representations as one transaction.

[54] United States v. Attaway, 211 F. Supp. 682 (W.D. La. 1962) (loans by plaintiff in exchange for checks, accompanied by defendant's oral promises and representations regarding payment of interest).

[55] United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1965). The plaintiff purchased the right to distribute the defendant's products. The plaintiff subsequently purchased goods from the defendant for resale; however, since the plaintiff was not in the position to do the reselling himself, he commissioned the defendant to resell the products for him.

[56] Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied*, 382 U.S. 903 (1965). The seller disseminated letters describing a motel venture and gave "tentative receipts" for the initial value furnished by the buyer.

[57] Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963), *aff'd*, 414 Pa. 253, 199 A.2d 428 (1964), wherein a vacuum cleaner was sold to the plaintiff for an inflated price and the seller promised the plaintiff a certain sum for every cleaner sold to persons recommended by the plaintiff. Considering all the circumstances, it was held that there was no "security." *Ibid.* Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964) (overcharge for water softener with referral agreement; *held*, no "security"); Yoder v. So-Soft, Inc., 202 N.E.2d 329 (Ohio C.P. 1963) (overcharge for water softener with referral agreement; *held*, a "security"). *Cf.* Fidelity Credit Co. v. Bradford, 177 So. 2d 635 (La. Ct. App.), *appeal denied*, 248 La. 430, 179 So. 2d 273 (1965) (vacuum cleaner plus referral agreement; overcharge not clear).

[58] Farrell v. United States, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964). *Farrell* involved the sale of trust deed and mortgage notes (or interests therein) to buyers, together with management and service contracts. For details of facts, see the related opinion in Los Angeles Trust Deed & Mortgage Exch. v. SEC, 264 F.2d

promises of the seller plus the written promises of a third party.[59] Oral unilateral offers of payment for services have also been found to be transactions eligible for security classification.[60]

It is abundantly clear, then, that the term "transaction," as used in the suggested test for identifying a security, is a collective one. Prior to analyzing a transaction for its security characteristics, the courts and agencies determine the dimensions of the transaction by integrating separate but related transfers, agreements, representations, and surrounding circumstances.[61] The significance of this practice lies in its effect on subsequent steps of the analytical process. As the content of a transaction is expanded to include more events and circumstances, there is a correspondingly greater chance of finding that the transaction possesses all of the essential characteristics of a security. In other words, by conglomerating a number of events into a composite transaction, the courts and agencies have often facilitated the task of finding that the transaction is endowed with all the distinguishing features of a security. Those qualities will now be considered seriatim as they appear in the proposed formula.

(2) Furnishing of Initial Value.—Of course, value can be furnished in the form of money, property,[62] or services.[63] Once value has been furnished by the buyer, a number of events may follow, including the transfer of tangible property from the seller to the buyer. At first blush it might appear as though the buyer, having received specific tangible value in return, can no longer claim that any part of his initial value is still invested. The fact that the buyer receives tangible property in return for his value may signal the need for unusually careful analysis, but it by no means precludes the

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199, 202-03 n.3 (9th Cir. 1959). See also SEC Securities Act Release No. 3892, CCH FED. SEC. L. REP. ¶ 76559 (Jan. 31, 1958); Op. Cal. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70383 (May 23, 1958).

[59] Bellerue v. Business Files Institute, Inc., 61 Cal. 2d 488, 393 P.2d 401, 39 Cal. Rptr. 201 (1964). Corporation *A* agreed to sell stock in corporation *B* to the buyer in exchange for the buyer's loans to corporation *B*. Corporation *B* executed its notes payable to the buyer in the amount of the loans. The notes would have been exempt, but the combination of steps was an investment contract.

[60] SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961).

[61] Some recounts of relevant surrounding circumstances read very much like travelogues. See Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965).

[62] Jackson v. Robertson, 90 Ariz. 405, 368 P.2d 645 (1962); State v. Davis, 131 N.W.2d 730 (N.D. 1964) (buyer exchanged stock for notes).

[63] SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961).

possibility that the whole transaction[64] constitutes a security. Even if the buyer receives tangible property in exchange for his original value, the question is still whether the transaction exhibits the "economic realities" of a security. In the proposed test, one of the most important economic characteristics of a security is the fact that the buyer's initial investment is somehow, considering the effects of the entire transaction, subjected to the risks of an enterprise. The discussion now passes to an analysis of the risk issue.

(3) Risk of Loss of Initial Value.—Risk of loss of initial value is an essential attribute of a security. This proposition can be traced to the most prestigious of sources. Although not often cited, the following language constitutes the core of Mr. Justice Jackson's rationale in *SEC v. C. M. Joiner Leasing Corp.*:[65]

> It is clear that an economic interest in this [enterprise] . . . was what *brought into being* the instruments [evidencing real property interests] that defendants were selling and gave to the instruments *most of their value* and all of their lure. The trading in these [interests] . . . had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end.[66]

Without the enterprise, there would be *no value* to anyone's real property interest.

The Court's concern is clearly focused on the relationship between the success of the enterprise and the *preservation or deterioration of the value* which the buyer *originally furnished* in the alleged security transaction. The fact that the buyer would have been left without "any value" if the enterprise had failed made it crystal clear that the initial value furnished by the buyer was subject to the risks of the enterprise. The fate of the buyer's initial investment was tied to the success of the venture, a circumstance which the Court considered critically relevant to the need for securities law protection.

Joiner isolated the element of *risk to initial value* as one of the essential features of a "security." While it has been said that *Howey* was a clarification of *Joiner*,[67] one wonders whether the

[64] All the constituent elements of the transaction must be considered. See text accompanying notes 48-61 *supra.*

[65] 320 U.S. 344 (1943). The following passage is more frequently cited:

> Novel, uncommon, or irregular devices, whatever they appear to be, are also reached [by the federal securities laws] if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as . . . "any interest or instrument commonly known as a 'security.'" *Id.* at 351.

[66] *Id.* at 349. (Emphasis added.)

[67] Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728 (1961).

Howey formula's shift in emphasis — from risk of initial value to the expectation of future profits — is faithful to Mr. Justice Jackson's penetrating analysis in *Joiner*.[68] Many state and federal opinions have cited both Supreme Court cases,[69] but the risk of loss notion articulated in *Joiner* has not been stressed nearly as much as the *Howey* formula with its heavy emphasis on the expectation of future profits.

Perhaps a renaissance of the risk factor is developing, however. A recent federal decision, *SEC v. Latta*,[70] and a state decision, *Silver Hills Country Club v. Sobieski*,[71] contain explicit language recognizing risk to initial investment as an essential characteristic of a security. In the *Latta* case, the court observed: "Unless the defendant is successful in [her enterprise] . . . the contracts [sold to the buyers] will remain *scraps of worthless paper*."[72] In deciding the "crucial question" of whether the transaction at bar came within the "regulatory purpose" of the securities laws, the *Silver Hills* court isolated the risk to the buyer's initial investment as the most important aspect of the transaction.[73]

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[68] Mr. Justice Jackson did not take part in the *Howey* decisions.

[69] *E.g.*, Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *petition for cert. dismissed per curiam*, 347 U.S. 925 (1954); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961); Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 809 (1965), *cert. denied*, 382 U.S. 903 (1965).

[70] 250 F. Supp. 170 (N.D. Cal.), *aff'd per curiam*, 356 F.2d 103 (9th Cir. 1965), *cert. denied*, 384 U.S. 940 (1966). Estelle Latta, undaunted by the passage of time and the policies of the law disfavoring endless litigation, continues her campaign to cause a redistribution of the estate of Mark Hopkins, who shuffled off this mortal coil more than eighty years ago. To finance her endeavor, she sold, for one hundred dollars each, assignments of 1/21,000 of any redistribution that she might obtain. It is not clear from the opinion how much gain was expected to accrue to the purchasers of these fractional interest assignments, but one thing was certain: Unless Estelle Latta was at least partially successful, the money paid for these unlikely instruments would, as far as the hapless buyers were concerned, join Mr. Hopkins in the great beyond.

[71] 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The promotor of a country club sold initial memberships for substantial sums. The proceeds were used to finance completion of club facilities and other organizational expenditures. Purchasers of memberships received no interest in the assets or profits of the club but were granted only the right to use the facilities of the club when it was completed. Thus, while the profits expected by the buyers were difficult to identify and assess, it was clearly possible that, if the seller failed to complete the club, a substantial part of the buyers' purchase value would dissipate forthwith in the manner so vividly portrayed by those fleeting little money bags with wings which appear in the cartoons.

[72] 250 F. Supp. at 173. (Emphasis added.) The risk that has been discussed at this point in the article is simply the risk that the buyer's original investment will become *worthless or worth less*. "This is a situation in which the economic welfare of investors is 'inextricably woven' with the ability of the promoter to carry out [the enterprise] . . . ." *Id.* at 173.

[73] 55 Cal. 2d at 815, 361 P.2d at 908, 13 Cal. Rptr. at 188.

These cases represent no shockingly new analytical approach to identifying a security, as some would seem to think.[74] They are true to highly respectable judicial attitudes, such as those in *Joiner*. There could be a deceptively obvious reason why many opinions (including *Howey*[75]) have taken the different tack of placing principal emphasis on the fact that the buyer was led to expect future profits. First, risk to initial value is generally accompanied by promises or representations which cause the buyer to expect a rather clearly identifiable sort of pecuniary profits in the future.[76] Second, it seems true that the buyer's reasonable expectation of future profits is often somewhat easier to detect than the element of risk to initial investment, as will be seen. The combination of these two phenomena may account for the bias of the decisions in favor of adopting the expectation of future profits as the most significant factor in identifying a security.[77]

In any event, while it may be generally harmless, and often more convenient, to gloss over the risk characteristic, there are at least two situations in which this sort of imperfect analysis will lead to improper results:

(1) In some cases, the profits expected by the buyer may be difficult to identify and assess; this would be especially true if the term "profits" were construed narrowly to mean only a share of the internal net profits shown on the income statement of an enterprise.[78] At the same time, there may be a serious risk of loss of initial investment. If the pivotal issue is whether there is a reasonable expectation of future profits, the transaction may be excluded from security classification because the adjudicator is uneasy about the precise nature of the profits expected. It is submitted that such a resolution would be erroneous and inconsistent with the purposes of the securities laws. Substantial determinative weight should be attached to the factor of risk to initial investment. Where the evidence to support a reasonable expectation of future profits is tenuous or difficult to interpret, the presence of risk to original value should be examined carefully and employed as a complementary factor to determine the result.[79]

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[74] See, *e.g.*, Note, 14 HASTINGS L.J. 181-82 (1962).

[75] SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[76] See Note, 50 CALIF. L. REV. 156, 159 (1962).

[77] See SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[78] This is the issue previewed in note 42 *supra*. It will be discussed later at greater length. See text accompanying notes 146-59 *infra*.

[79] The California authorities seem ready to adopt this view. See Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1, 7-8 (1963).

(2) On the contrary, however, a transaction may be replete with promises and representations which amply support the buyer's reasonable expectation of future profits, but the effect of the transaction may not be to subject any of the buyer's initial value to the risks of an enterprise.

The foregoing observations lead naturally into the next item of discussion, which is an investigation of the various ways in which the buyer's initial investment can be subjected to the risks of an enterprise.

(a) Manifestations of Risk.—Subparagraphs (3)(a), (b), and (c) of the proposed formula[80] are shorthand and highly generalized descriptions of the basic ways in which the buyer's initial investment can be subjected to the risks of an enterprise. In testing for the net effect of a transaction on the buyer's initial value, the economic significance of each constituent event of the whole transaction must be carefully assessed. In some transactions, the element of risk is easily isolated; in others, the risk is more subtle and more difficult to identify with precision.[81] Most adjudicators, sensing the presence of a sufficiently troublesome degree of risk to original value, either fail to analyze the danger of loss further or merely advert to it in the most general terms. While the decisions usually reach a correct result without close and accurate scrutiny of the risk factor, they are, by reason of their deficiencies in this respect, considerably less valuable as precedent.[82]

In the interest of explicating the various forms in which risk is manifested, there follows a detailed analysis of a number of the specific mechanics by which the buyer's initial value can be subjected to the risks of an enterprise. Each subheading will indicate the kind of property which the buyer receives in exchange for his initial investment, and the relationship, if any, created between the buyer and the risk enterprise.

(i) Intangible Proprietary Interest in the Enterprise: Repayment Upon Termination Plus Share of Profits and Losses.—

[80] These subparagraphs appear at the text following note 47 *supra.*

[81] Some mention was made of these problems in note 41 *supra.*

[82] "It has been said that there should be no hard and fast rule by which to determine whether that which is offered to a purchaser is [a security] . . . since such a determination would act as a guide post in the aid of the unscrupulous in circumventing the law." Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 255, 199 A.2d 428, 429 (1964), *affirming* 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963). While the quoted passage is undoubtedly correct in its statement regarding the desirability of rigid rules, no concern for keeping offerors guessing should stultify the development of a rational analytical approach (together with some shorthand guidelines) for appraising the "security" aspects of a transaction.

These are the transactions in which the purchaser receives a proprietary interest in the enterprise. He has a percentage share of the enterprise assets or entity, but he also understands that his initial investment will bear a percentage share of enterprise losses.[83] Hereafter, such arrangements will be referred to as "percentage-share" or "proprietary-interest" transactions. Under such arrangements, the buyer's initial value is placed at the risk of the business enterprise in the most unequivocal way, in that he places his initial value at the disposal of the enterprise in exchange for a proprietary interest.[84] The initial investment flows into the stream of general enterprise capital and becomes fully exposed pro rata to all of the failures of operations, often serving more or less (depending on the particular agreement) as a shield or cushion for creditors. Upon termination of the enterprise, the buyer has no claim if his original value has been wiped out by deficits.

Thus, whenever the buyer receives, in exchange for his initial value, a proprietary interest in the enterprise, the presence of risk to his original investment is rather easy to detect.

(ii) Intangible Claim Against the Enterprise: Creditor's Right To Receive Repayment and Interest.—Here the buyer relinquishes specific ownership of his initial investment and takes in return a creditor's intangible claim against the enterprise.[85] The initial investment merges into the general enterprise capital, just as it does in the proprietary interest arrangement. Unlike the buyer of a percentage share, however, the purchaser does not agree to bear the losses of the enterprise pro rata, and his value is usually to be

[83] *Stock; preorganization certificates and subscriptions*: Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964); Jackson v. Robertson, 90 Ariz. 405, 368 P.2d 645 (1962); People v. Smith, 180 Cal. App. 2d 420, 4 Cal. Rptr. 282 (Dist. Ct. App. 1960). See also Bellerue v. Business Files Institute, Inc., 61 Cal. 2d 488, 393 P.2d 401, 39 Cal. Rptr. 201 (1964); Donovan v. Dixon, 261 Minn. 455, 113 N.W.2d 432 (1962) (guaranty fund certificates).

Partnership interests; investment units: Smith v. Sherman, 206 Cal. App. 2d 93, 23 Cal. Rptr. 487 (Dist. Ct. App. 1962); Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (Dist. Ct. App. 1961); Conroy v. Schultz, 194 A.2d 20 (N.J. Super. Ct. 1963); Op. Nev. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70691 (Nov. 12, 1965).

[84] Under the partnership and corporate forms, the buyer's ownership in specific property is severed, and he takes an interest in the factitious business entity. In joint adventures or other informal enterprise organizations, the buyer may furnish specific property in which he retains an ownership interest. However, vis-a-vis outsiders dealing with the venture, the property is considered a capital contribution and bears its share of enterprise losses, without the buyer's being able to assert his ownership interest against such outsiders.

[85] United States v. Attaway, 211 F. Supp. 682 (W.D. La. 1962) (checks with seller's agreement to pay interest if not cashed); State v. Davis, 131 N.W.2d 730 (N.D. 1964) (6 year notes). See also SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961) (loan notes).

returned according to a schedule, whether or not the enterprise has suffered losses.

In some cases, there is sufficient junior percentage-share-type investment to absorb losses before they erode the enterprise assets to a point where the creditor's original investment is jeopardized. Holders of debt may not always be so fortunate, however, since not all enterprises are financially structured to include percentage-share junior investment,[86] and those which are may provide only a thin cushion for creditors.

In short, the original value furnished in a debt transaction may be somewhat more protected from the ravages of enterprise failure than is the value furnished for a proprietary interest. A secured debt is merely farther removed from the front lines of risk, for failure of the enterprise is as likely to take its toll of the property securing the debt as it is the rest of the assets.

It seems safe to say, then, that there is a significant degree of risk to initial value furnished in exchange for debt obligations.

(iii) Tangible or Intangible Property: Buyer Retains Specific Ownership but Recommits Property to Use or Employment by the Enterprise.—In such a transaction, the buyer receives an interest in specific property. Such interest may have a present fair market value, independent of the future success of an enterprise,[87] equal to the original value furnished by the buyer.[88] The critical component of the transaction is the fact that the buyer, while retaining ownership of the specific property, immediately recommits it for use or employment by an enterprise. The vehicle by which the property is recommitted to the enterprise is often a management or service agreement. The property received and recommitted by the buyer may be tangible[89] or intangible.[90] The enterprise to which the

86 Individuals may operate the enterprise with capital derived solely from the issuance of debt. See Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942), *aff'd*, 147 F.2d 916 (3d Cir.), *cert. denied*, 325 U.S. 859 (1944). See also SEC v. Addison, *supra* note 85.

87 Payment of initial value in recognition of the yet unrealized success of an enterprise is discussed in text accompanying notes 102-10 *infra*.

88 The transaction may differ in this respect from the "overcharge" situations discussed in text accompanying notes 111-18 *infra*.

89 SEC v. W. J. Howey Co., 328 U.S. 293 (1946); United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1966) (buyer purchased goods at wholesale and commissioned seller to resell at retail); SEC v. Great W. Land & Dev., Inc., CCH FED. SEC. L. REP. ¶ 91537 (D. Ariz. 1965) (Transfer Binder 1964-1966), *rev'd on other grounds and remanded*, 355 F.2d 918 (9th Cir. 1966) (buyer received interest in real property but agreed to let seller list and sell it); SEC v. Willoughby Coin Exch., CCH FED. SEC. L. REP. ¶ 91355 (S.D. Cal. 1964) (coin collection man-

property is recommitted need not be that of the seller of the property.[91]

The principal objection to classifying such transactions as securities seems to stem from the fact that the buyer may receive property with an independent present market value equal to the original value furnished. If the buyer takes a full *quid pro quo*, how can he be said to have placed any value at the risk of an enterprise? This is the question which was raised by the two lower courts in *SEC v. W. J. Howey Co.*,[92] and to which the Supreme Court responded tersely: "We reject the suggestion . . . that [a security] . . . is *necessarily* missing where the . . . tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole."[93] The word "necessarily" is critical, for it is doubtful whether the Court would have applied its holding to some simple variants of the *Howey* facts. For example, *B* purchases crop-producing property from *S*, who has vigorously expounded the profits to be made from working the land. *B* then shops around for someone to manage his land and later signs a land service contract with a third party. The theory of *Howey* would not seem to be apposite. *B*'s original value was not subjected to the risks of an enter-

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agement); SEC v. Comstock Coin Co., CCH FED. SEC. L. REP. ¶ 91414 (D. Nev. 1964) (Transfer Binder 1964-1966) (coin collection management); SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962) (sale of land with development and management contract); Op. Fla. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70653 (Dec. 14, 1964) (land with management contract).

90 United States v. Herr, *supra* note 89 (franchise entrusted to another for exploitation); Farrell v. United States, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964) (sale of mortgage notes with management contract); Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961) (another stage of the *Farrell* litigation); SEC Securities Act Release No. 3892, CCH FED. SEC. L. REP. ¶ 76559 (Jan. 31, 1958) (mortgage note servicing); Op. Cal. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70383 (May 23, 1958).

Of course, the intangible which is sold to the buyer may itself constitute a security without being recommitted to an enterprise. In Farrell v. United States, *supra*, the defendant purchased individual makers' notes and resold them to the public with service contracts. The first question is whether the notes were securities, either at the time of the making or as redistributed by the defendant. The second question is whether the transaction, consisting of the sale of the notes together with the management contract, was a security. See Op. Cal. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70250 (Dec. 29, 1954). The question of whether an isolated and private promissory note is a security at the time of making will be discussed later. See text accompanying notes 184-204 *infra*.

91 SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962).

92 60 F. Supp. 440, 442 (S.D. Fla.), *aff'd*, 151 F.2d 714, 717 (5th Cir. 1945), *rev'd*, 328 U.S. 293 (1946). See also SEC v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941), wherein the court noted that "contracts for the sale and purchase of a tangible and identifiable commodity, title to and possession of which passes to the purchaser, are not ordinarily regarded as [securities]." *Id.* at 650.

93 SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946). (Emphasis added.)

prise in a series of steps which can reasonably be treated as a single integrated transaction. In other words, the troublesome risk to *B*'s original investment must arise from the fact that, even though he receives property of equal value, he *immediately recommits* it to the risks of an enterprise *as part of the same transaction.* The net effect is similar to that of the one-step transaction, in which the initial value itself becomes part of the capital of an enterprise and in which the buyer, instead of receiving an interest in specific property distinct from the enterprise, takes a proprietary interest or debt-holder's claim.[94]

The similarity is not complete, however, for the species of risk is distinctly different from that in transactions where the initial investment flows into the general capital of the enterprise. Here, although his assets are in some sense "employed in the enterprise,"[95] the buyer retains ownership of specific property which is not subject directly to the internal operating losses of the enterprise. Nevertheless, the buyer's property is subject to various other operational hazards of the enterprise. For instance, if the buyer's property were productive crop land and the enterprise managing it became defunct while the crops were growing, the damage might be so serious that both the crop and a part of the intrinsic value of the land (representing initial investment) would be lost.[96] It might be argued that the person who has owned land for some time undertakes the same risk when he turns the land over to a management enterprise.[97] The answer to this contention seems to be that, in the latter case,

[94] In United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied,* 382 U.S. 999 (1966), the buyer furnished initial value to the seller for a distributorship franchise. He then furnished additional value to the seller for goods at wholesale. As part of the transaction, he agreed to have the seller resell the goods through the seller's facilities. Thus, the buyer purchased and recommitted both intangible and tangible property. In assessing the net effect of the entire transaction, the court stated: "[R]egardless of the statement in the agreement . . . that the relationship created . . . was that of vendor and purchaser, we construe it to be . . . [a security]." *Id.* at 610.

[95] SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946). One way of describing the difference in risk would be to distinguish between the cases where the initial value is used *in* the enterprise (see text accompanying notes 83-86 *supra*) and cases where property is received in exchange for initial value and is then recommitted for use *by* an enterprise.

[96] The risk is greater where the management enterprise may sell the property. *E.g.,* SEC v. Comstock Coin Co., CCH FED. SEC. L. REP. ¶ 91414 (D. Nev. 1964) (Transfer Binder 1964-1966).

[97] As long as the landowner did not pay more than fair market value for the management services and did not contribute his land as capital in a joint venture with the management enterprise, it is doubtful that such a transaction would be considered a security, no matter what kind of lavish promises of fabulous profits were made by the management enterprise.

the owner of the land has not, as part of the same transaction, made a new investment by parting with cash or one kind of property in exchange for a new kind of property. The securities laws are concerned mainly with protecting the buyer when he exchanges what he already has for something new.

The risk arising where property is received and immediately recommitted to an enterprise does not depend on the size or quantity of the property. The small size or quantity of property may tend to explain why it was recommitted, for the property may be so small that it cannot be economically exploited except in conjunction with other similar property. Once the property is placed under the control of an enterprise, however, the risk is the same whether the property could have been productively employed or managed by the buyer or not. The *Howey* opinion, by stressing the small size of the tracts of crop-growing land sold to the buyer in that case, seemed to indicate that small size is a *sine qua non* of risk to initial value.[98] Indeed, some courts have interpreted *Howey* as holding that small size is a necessary condition for a security finding.[99] However, other cases, involving larger quantities of property, have found that a security was involved,[100] apparently on the theory that once the

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[98] SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946). "Indeed, individual development of the plots of land . . . would seldom be economically feasible due to their small size. Such tracts gain utility . . . only when cultivated and developed as component parts of a larger area." *Id.* at 300.

[99] *E.g.*, Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (Dist. Ct. App. 1964), wherein the buyer purchased eighty acres of growing grapes. The buyer agreed to bear the risk of loss while the crops were growing and to take responsibility for harvesting. The seller agreed to care for the crop while it was growing and to arrange for shipping. One branch of the court's rationale was based on the fact that the buyer retained control over the crops — the so-called "joint venture" theory. See text accompanying notes 123-31 *infra*. However, the court also stated:

> Plaintiffs did not buy property synthetically divided into *small units* in order to mask *intangible interests* in the total business enterprise. . . . Plaintiff's profit, if any, would be determined by the difference between cost and selling price of this particular 80 acres of grapes, not by fractional participation in the profits *or losses* of the seller's business operations. *Id.* at 425, 41 Cal. Rptr. at 871. (Emphasis added.)

[100] United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1966) (quantity of goods for resale not so small that they could not be sold by purchaser); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *petition for cert. dismissed per curiam*, 347 U.S. 925 (1954) (twenty acres); SEC v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941) (twenty acres). Sarmento v. Arbax Packing Co., *supra* note 99, gives a rendering of *Howey* which is curious in more than one respect. The California court seems to indicate that the buyers in *Howey* received "fractional interests in the total business enterprise" so as to have a "fractional participation in the profits or losses of the [management enterprise's] business operations." *Id.* at 871, 41 Cal. Rptr. at 425. The buyers in *Howey* would certainly have been astounded if they had been told that their plots of land were subject to internal operating losses of the management corporation, and the seller would have been equally surprised to discover that the buyers had a

property is recommitted to the enterprise, the same risks ensue no matter what the property's size.[101]

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right to share in the operating profits of the management corporation or a right to share in the proceeds of liquidation. In committing their property to the control of the management corporation, the buyers did not acquire an enterprise interest similar to that of the corporation's stockholders; the buyers did not agree that their land would bear a share of the internal operating losses shown on the income statement of the management enterprise.

A separate problem is the manner in which a number of buyers are to share in the proceeds derived from the several separately owned pieces of property under the supervision of the management enterprise. This matter will be treated later, but at this point it would be well to point out that a careful reading of the lower court *Howey* opinions indicates that, although the management enterprise pooled the fruit from all plots for purposes of marketing, each owner received net proceeds based on the amount of fruit harvested from his land, not a proportionate share of the proceeds based on the ratio which the quantity of his land bore to the total quantity of land under the control of the management enterprise. Each purchaser "looked to the fruitage of his own grove and not to the fruitage of the groves as a whole." SEC v. W. J. Howey Co., 151 F.2d 714, 717 (5th Cir. 1945), *rev'd,* 328 U.S. 293 (1946).

Thus, the future profits of each purchaser's land were not diminished pro rata by the lack of profits on other land. This was clear in Blackwell v. Bentsen, *supra,* and appears to have been the case in SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962) and SEC v. Bailey, *supra.*

In any event, the method of distributing proceeds from managed property relates to *future profit experience* and not to risk to the buyer's original value. Even if each landowner takes a share of overall proceeds based on the size of his land, so that some owners' profits are reduced by inferior production on other land, no owner's land itself (representing his initial investment) would be subject to losses resulting from lack of production from another's property.

101 A somewhat more difficult problem is presented by the following set of facts. *B* purchases property from *S.* At the time of purchase, it is virtually certain that *B* will be forced to relinquish the property to the supervision (and the attendant risks) of a management enterprise, not just to generate income, but to preserve the value of the property at the level of his initial investment. At the time the transaction is attacked as a "security," neither *B* nor other buyers have recommitted their property to a management enterprise.

In such a case, since *B* does not concurrently recommit his property for use or employment by an enterprise, it is difficult to say that *B*'s original value was subjected to the risks of an enterprise as part of a transaction connected with *S.* If it were clear that the market value of the property could not be preserved without its being relinquished to supervisory control, perhaps it could be said that part of the original value was paid in recognition of the future success of the management enterprise to which *B* would ultimately have to recommit his property. This would place the result on a rationale applicable to the fact pattern discussed under the next heading, in which the buyer furnishes his initial value in recognition of the yet unrealized success of an enterprise with which the buyer may have no legal relationship. In such a case, part of the present value of the property purchased is clearly attributable to the anticipated but unaccomplished success of an enterprise.

It might also be reasoned that, since *S* could have reasonably foreseen that *B* would be forced to recommit the property to the risks of an enterprise, the sale by *S* and any subsequent management arrangement entered into by *B* should be integrated into one transaction.

The size of the property would be relevant to the element of risk to initial value if it tended to prove the virtual certainty that the property received by the buyer would have to be recommitted to a management enterprise *to maintain its fair market value at the level of initial investment.* Small size would not be relevant to the issue of risk if it proved only that the property would have to be recommitted *to generate income.*

(iv) Tangible or Intangible Property: Original Value Paid in Recognition of the Yet-Unrealized Success of an Enterprise; No Legal Relationship With Enterprise Necessary.—Sometimes the buyer receives property other than that described in the preceding three subsections.[102] The amount of initial value which the buyer pays for the property is arrived at by taking into account the yet-unrealized success of an enterprise. If the expected success of the enterprise is not forthcoming, the value of the property purchased is deflated pro tanto to a level below the initial investment. The enterprise may[103] or may not[104] be that of the seller of the property. It is not necessary that the buyer have any continuing legal relationship with the enterprise.[105]

Unlike the situations already canvassed, the buyer does not receive a proprietary interest or a creditor's claim for repayment; nor does he receive property that is recommitted for use by an enterprise. Instead, the transaction is such that some portion of the *present value* of the property received by the buyer can only be explained in terms of the *future successful operations* of an enterprise. Of course, the foregoing characterization may apply to the percentage-share, debt, and "recommitted property" transactions already examined, but such arrangements involve other more discernible risks which emanate from the very nature of the legal relationships created between the buyer and the risk enterprise.[106] A subsisting legal relationship

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[102] This assumption is made only for the purposes of analysis. Note, however, that transactions often possess more than one of the types of risk discussed in text accompanying notes 83-101 *supra* and 103-18 *infra.*

[103] SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943); United States v. Schaefer, 299 F.2d 625 (7th Cir.), *cert. denied,* 370 U.S. 917 (1962); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965); SEC v. Latta, 250 F. Supp. 170 (N.D. Cal.), *aff'd per curiam,* 356 F.2d 103 (9th Cir. 1965), *cert. denied,* 384 U.S. 940 (1966); Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); People v. Woolson, 181 Cal. App. 2d 657, 5 Cal. Rptr. 766 (Dist. Ct. App. 1960) (a mélange of ill-drawn agreements involved in a bizarre scheme to sell gold to the Mexican government).

[104] Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied,* 368 U.S. 824 (1961).

[105] SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943); Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied,* 368 U.S. 824 (1961).

[106] In Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), the buyer received, in consideration of his initial value, a "membership" in a country club that was not yet completed. The "membership" gave him the right to use all club facilities. However, he did not receive any interest in the country club enterprise or its future profits, and he was required to pay monthly dues if and when the club was completed. Thus, it cannot be said that the risk to the buyer's original value arose by virtue of his having a percentage-share interest or a creditor's claim. The risk stemmed from the fact that his initial value was paid in recognition of the future completion and operation of the club by the seller's enterprise; that is, part, if not all, of

need not be the basis of risk, however. The failure of an enterprise may, by force of circumstances,[107] depress the value of property received by the buyer. If part of the present value of such property is attributable to the anticipated accomplishments of an enterprise, a portion of the buyer's initial investment may vanish if success is not achieved.

This type of risk is frequently manifested in situations where the buyer purchases property for capital appreciation on the strength of representations that gains will be forthcoming upon successful completion of various developmental projects.[108] The purchase price has two components: the inherent value of the property, aside from the expected effect of the developmental enterprise, plus an increment which represents the discounted value of ultimate enterprise success. Thus, if the developmental enterprise fails, the buyer not only misses his capital gains but also suffers a loss of his initial investment.

The same type of risk to initial value may attend the purchase of an intangible right to future payments, *e.g.*, a percentage interest in royalties[109] or a share in the future distribution of an estate which is presently in litigation.[110]

(v) Property With Fair Market Value Less Than Initial Value: Conditional Right To Receive Payments.—The hybrid transactions to be discussed under this heading have caused a great deal of consternation in the courts, and understandably so. The basic factual pattern underlying the problem can be stated quite simply. *B* purchases property (hereafter referred to as the "purchased property") from *S* at more than its current fair market value. For pur-

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the value of the membership was attributable to the successful materialization of club benefits.

107 In SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943) and Roe v. United States, 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961), this force of circumstances lay in the fact that the oil content of the buyer's property would be taken to be more or less similar to that of nearby property on which drilling tests were being conducted. In Silver Hills Country Club v. Sobieski, *supra* note 106, the membership would not have been worth very much without the accompanying golf course, bar, and swimming pool.

108 Some of this type of risk seems to have been present in several of the productive crop land cases already analyzed. See, *e.g.*, SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962), in which part of the initial value seems to have been paid in recognition of the future success of cultivation operations being conducted on surrounding land.

109 United States v. Schaefer, 299 F.2d 625 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965).

110 SEC v. Latta, 250 F. Supp. 170 (N.D. Cal.), *aff'd per curiam*, 356 F.2d 103 (9th Cir. 1965), *cert. denied*, 384 U.S. 940 (1966).

poses of focusing on the issues, it will be assumed that the purchased property is not a proprietary interest or debt-holder's claim; that it is not recommitted to use by an enterprise;[111] and that no part of its present fair market value is attributable to the anticipated but unrealized success of an enterprise.[112] *S* promises to pay *B* a certain amount upon the occurrence of a specified event, *e.g.*, *S*'s making sales to persons whose names were furnished by *B* (customarily called "referral sales").[113]

The confusion probably springs from two seemingly applicable propositions which tend to militate against holding that such a transaction is a security. First, since the buyer receives the purchased

[111] We have already dealt with the situation in which as part of the transaction, the property received is recommitted to employment by an enterprise. See text accompanying notes 87-101 *supra.*

[112] Sometimes the initial value furnished by the buyer is paid in recognition of the future success of an enterprise (particularly a developmental enterprise) with which the buyer may have no legal relationship. This problem was dealt with in text accompanying notes 102-10 *supra.*

[113] Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963), *aff'd,* 414 Pa. 253, 199 A.2d 428 (1964) (vacuum cleaners); Fidelity Credit Co. v. Bradford, 177 So. 2d 635 (La. Ct. App.), *appeal denied,* 248 La. 430, 179 So. 2d 273 (1965) (vacuum cleaners; overcharge not clear); Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964) (water softener); Yoder v. So-Soft, Inc., 202 N.E.2d 329 (Ohio C.P. 1963) (water softener).

In Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., *supra,* the court held that no security was involved because the buyer was to secure the additional payments through "his own efforts." Thus, the decision rested partially on the "joint venture" theory, which will be considered later. See text accompanying notes 123-31 *infra.* The second leg of the opinion was based upon the court's interpretation of the word "profits" in the *Howey* formula. The court arrived at the highly questionable conclusion that the "profits" which the buyer is led to expect must be payable only if the risk enterprise makes a profit. Thus, the court impliedly excluded from security classification a transaction wherein the buyer furnishes initial value in consideration for a right to receive a sum certain, contingent upon the happening of a specific event, but unrelated to the operating profits of the enterprise. See text accompanying notes 146-59 *infra.*

Emery v. So-Soft, Inc., *supra,* was decided on the same two grounds announced in Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., *supra.* In both cases the courts intimated that the payments for referral sales were simply compensation to the buyers for furnishing sales leads and introducing the seller's product to their friends. If it be assumed that the buyers were receiving no more than fair market value for their so-called services, then the overcharge remains unexplained. Certainly the buyers did not pay the overcharge for the right to receive the fair market value of their services.

Yoder v. So-Soft, Inc., *supra,* involved facts very similar to those in Emery v. So-Soft, Inc., *supra,* but the court seemed to have a better insight into the financial realities. In holding that the transaction constituted a security, the court noted that "the sale of the [water] softener was nothing more than a 'gimmick' used by the defendant to make the sale of a money making scheme to gullible purchasers." Yoder v. So-Soft, Inc., *supra* at 330. This is in contrast to Fidelity Credit Co. v. Bradford, 177 So. 2d 635, 640 (La. Ct. App.), *appeal denied,* 248 La. 430, 179 So. 2d 273 (1965), wherein the court, without any analysis, concluded that the payments promised to the buyer were "advertising gimmicks" used to sell vacuum cleaners.

property, one is tempted to say that the buyer has completed a simple purchase, has gone his way with property in hand, and should not be heard to say that his initial value has been subjected to the risks of an enterprise. This approach overlooks the spread between the original value furnished and the current fair market value of the purchased property. Second, a problem is raised by the general principle that a "bad bargain" is of no concern to the law. This principle does not seem applicable to the situation in which the buyer receives a conditional right to future payments and where he has reason to believe not only that the value differential will be recouped but also that he may receive benefits over and above the amount of the overcharge.

It is submitted that the court, in *Yoder v. So-Soft, Inc.*,[114] correctly characterized the overcharge-sale-conditional-payment transaction as a novel method of financing, whereby the *overcharge spread* is subjected to the risks of an enterprise in the manner described under the previous subheading. For his overcharge, the buyer has received an intangible right to receive payments upon the happening of a certain event. This right to future payments has no present value except in terms of the future success of the enterprise. It seems that *Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc.*[115] and *Emery v. So-Soft, Inc.*[116] might have been decided differently if the specified amounts had been payable only out of profits made by the seller on each referral sale or out of the overall operating profits of the seller's enterprise.[117] The benefits expected by the buyer might then have been more speculative, but the fact that the buyer was entitled to a guaranteed amount on each referral sale, whether or not the risk enterprise had profits,[118] should not be controlling.

It seems safe to say that any improper analysis in the foregoing cases resulted from a failure to recognize the rather disguised form of risk to initial investment and from a narrow interpretation of the

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114 202 N.E.2d 329 (Ohio C.P. 1963).

115 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963), *aff'd*, 414 Pa. 253, 199 A.2d 428 (1964).

116 199 N.E.2d 120 (Ohio Ct. App. 1964).

117 The attitude of the Pennsylvania Supreme Court in the *Consumers Research* case can be gleaned from the following statement: "[T]he [buyer] . . . is not promised a share in the profits, but is given a *specific fee, regardless of profits* . . . ." Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 256, 199 A.2d 428, 429 (1964). The court should have considered what would have happened if the enterprise had become insolvent.

118 See text accompanying notes 146-59 *infra*.

word "profits" (in the *Howey* formula) to mean only payments made out of profits earned by the risk enterprise.

(b) Summary.—The foregoing exegesis of risk was meant to convey some notion of the multifarious character of *risk to initial investment.* It has been noted that the element of risk may be disguised so as to escape notice,[119] especially if the focal point of analysis is the *expectation of profits.* Moreover, if the term "profits" is construed narrowly and the risk factor is not properly identified, it is possible that certain transactions involving genuine risk to the buyer's initial value might escape security classification.[120]

Since there are a number of diverse forms of risk to initial investment, it would be very difficult to ascribe any definite meaning to the words "common enterprise" in the *Howey* formula. On balance, this phrase seems to be of little aid in the process of identifying a security.

Attention has also been called to a circumstance which tends to negate the existence of risk, *viz.*, the buyer's receipt of property, other than a proprietary interest in, or debt-holder's claim against, the seller's enterprise. The discussion so far has focused on situations in which there is risk to initial value despite the receipt of property.[121] Later, cases will be examined in which the receipt of property or services should be taken to exclude the presence of risk.[122]

By training the spotlight on risk to initial investment, it is not suggested that the other elements of the traditional *Howey* formula — lack of control over the enterprise and the expectation of profits — are not essential qualities of a "security." Recall that the basic objective of this inquiry is to isolate the characteristics of a transaction which create a need for the special fraud protection of the securities laws. It is clear that Congress and the state legislatures did not intend the securities laws to provide relief against fraud in all transactions. However, the special anti-fraud procedures, pro-

119 *Cf.* Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (Dist. Ct. App. 1964); Fidelity Credit Co. v. Bradford, 177 So. 2d 635 (La. Ct. App.), *appeal denied,* 248 La. 430, 179 So. 2d 273 (1965); Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964); Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964), *affirming* 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963).

120 Emery v. So-Soft, Inc., *supra* note 119; Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., *supra* note 119.

121 See text accompanying notes 87-118 *supra.*

122 See text accompanying notes 138-44 *infra.* See also text accompanying notes 92-95 *supra.*

tections, and remedies do seem pre-eminently appropriate where a buyer puts up initial value that will be subject to the perils of enterprise failure even when there is no fraud.

(4) Lack of Buyer's Familiarity With, or Control Over, the Enterprise.—The last statement is subject to one important qualification. The danger of fraud being practiced upon the buyer is considerably reduced when his initial investment is subjected to the risks of an enterprise with which he is familiar at the time of the transaction and over which he exercises management control. Under such circumstances, the buyer is hardly in a position to claim that he was induced to furnish value by means of misstatements or half-truths about the character of the venture. Moreover, if the buyer exercises his control prerogatives, he is in a better position to protect his original value from the hazards of enterprise operation. Thus, the so-called "joint venture" theory has been developed. Its effect is to exclude from the "security" category those transactions involving the subjection of the buyer's initial investment to the risks of an enterprise with which he is familiar and in which he plays an active management role.[123]

The use of the phrase "joint venture" to describe this judicial doctrine is rather anomalous. The principle should apply only when the buyer is intimately familiar with the enterprise and actively participates in its affairs. These are the special factors which protect the buyer against the dangers of fraud and risk.[124] However, it is perfectly possible to have a "joint venture" (in a more

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[123] Drug Management, Inc. v. Dart Drug Corp., CCH FED. SEC. L. REP. ¶ 91293 (D.D.C. 1963) (buyer purchased drugstore franchise); Weinstock v. L. A. Carpet, Inc., 234 Cal. App. 2d 809, 44 Cal. Rptr. 852 (Dist. Ct. App. 1965); Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 41 Cal. Rptr. 869 (Dist. Ct. App. 1964) (one branch of opinion); Hargiss v. Royal Air Properties, Inc., 206 Cal. App. 2d 406, 23 Cal. Rptr. 678 (Dist. Ct. App. 1962); Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied,* 382 U.S. 903 (1965); Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964) (one branch of opinion); Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964), *affirming* 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963) (one branch of opinion). *Contra,* Jackson v. Robertson, 90 Ariz. 405, 368 P.2d 645 (1962).

Under California law there is a specific exemption for "any bona fide joint venture interest, except such interests when offered to the public." CAL. CORP. CODE § 25100(m). Nonetheless, the cases applying the statute involve most of the same issues pertinent to the judicial doctrine. Note, however, that a side effect of including the "joint venture" theory in the statutory exemptive structure is to make a joint venture interest prima facie a security.

[124] Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807 (1965), *cert. denied,* 382 U.S. 903 (1965): The buyer "has an equal right of control . . . and [the] . . . right to know what is going on." *Id.* at 234, 204 N.E.2d at 809.

traditional sense) with passive members.[125] Presumably, such joint-venture interests would constitute securities.[126] It seems that "joint control" is the critical element; the buyer must play "no mere passive role."[127] It is therefore suggested that this doctrine be referred to as the "joint control" exception.

Some courts have liberally applied the theory to certain factual patterns. In one case, the court based its decision on the buyer's "equal *right* of control" and his "equal *right* to know what [was] . . . going on."[128] In another case, the court found that the buyer was taking part in a sales enterprise when his only chore was to write letters to his friends introducing the enterprise's product.[129]

Although the joint control concept has been rejected in some quarters,[130] it seems sound in principle and has been included as a component of the author's proposed formula for identifying a se-

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125 It seems that the essentials of a joint venture are simply "a community of interest . . . [and] an expectation of profit." *Id.* at 235, 204 N.E.2d at 810.

126 SEC Rule 3a11-1, 17 C.F.R. § 240.3a11-1 (Supp. 1966) defines "equity security" to include an "interest in a joint venture."

127 Weinstock v. L. A. Carpet, Inc., 234 Cal. App. 2d 809, 44 Cal. Rptr. 852 (Dist. Ct. App. 1965). "The parties are equal owners and stand on equal footing as entrepreneurs." *Id.* at 813, 44 Cal. Rptr. at 854.

128 Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied*, 382 U.S. 903 (1965). (Emphasis added.) The defendant wrote letters to a number of friends and relatives, offering investment units in a motel enterprise. It was anything but clear that the buyers actually knew "what was going on" at the time of purchase or that they would thereafter take an active part in management. It may be that the decision was influenced more by the private and isolated nature of the transaction than by the element of "joint control."

129 The prosecution failed to introduce evidence that the buyer had been told that he would "not be permitted to try his hand or abilities as a salesman." Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963), *aff'd*, 414 Pa. 253, 199 A.2d 428 (1964). The buyer was to receive certain payments if the seller's enterprise were successful in selling goods to the buyer's friends. The buyer wrote letters to his friends, telling them about the product and giving them advance notice that the seller would be in touch with them.

This "studied attempt to fleece purchasers of a 'Built-In-Vacuum System' by securing an unconscionable overcharge" also had its chain letter aspects. Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 254, 199 A.2d 428 (1964). The buyer was to receive payments if the seller completed sales with persons whose names were furnished *by the buyer's friends*. The court seemed to overlook the fact that the buyer had no control whatever over the latter sales.

The *Consumers Research* rationale was adopted in another case in which the buyer did not even write to his friends. Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964).

130 *E.g.*, Jackson v. Robertson, 90 Ariz. 405, 368 P.2d 645 (1962). "[T]he Securities Act was not enacted to protect any of the parties to this law suit. Nevertheless, the contract herein called for issuance of corporate securities which might very well have been foisted upon the investing public by any of the five men involved." *Id.* at 409, 368 P.2d at 648. The reasoning is specious, for the application of the joint control rule among active managers does not prevent a court from finding that a later transaction with outsiders constitutes a security.

curity. However, the exception should be applied only when the buyer's position truly reduces the possibility of fraud and gives him the power to affect the risk to his initial investment. At the time of the transaction, the buyer should possess both knowledge of the risk enterprise and the power to influence the course of its future operations. It seems highly questionable whether the joint-control theory should govern where the buyer assumes a management role *after* the purported security transaction but has had no knowledge of the risk enterprise prior thereto.[131]

(5) Reasonable Expectation of Benefits in Excess of Initial Value.—Thus far, two major characteristics of a security transaction have been examined: (1) risk to the buyer's initial value, and (2) the buyer's lack of familiarity with, or control over, the risk enterprise. At this juncture, it may well be asked whether these qualities alone are sufficient to distinguish a security from the universe of transactions.

(a) In General.—The question actually becomes: should the special fraud protection of the securities laws be applied to all transactions in which the buyer's initial value is subjected to the risks of an enterprise with which he is not familiar and over which he has no control? *Howey*[132] has answered this question in the negative. The seller must have induced the buyer to furnish initial value by means of promises or representations which give rise to a reasonable expectation of "profits." Thus, even though risk to initial investment may be the most economically troublesome quality of a security transaction (as has been earnestly contended), the Su-

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[131] In Drug Management, Inc. v. Dart Drug Corp., CCH FED. SEC. L. REP. ¶ 91293 (D.D.C. 1963), the buyer purchased a franchise for the operation of a specially constructed drugstore. The buyer was to operate the drugstore and thus would control the exploitation of the franchise *after* the alleged "security" transaction. There were no facts to indicate that the buyer had any knowledge of other enterprises in which such franchises had been employed. *Held,* no security. The franchising business seems to be booming from coast to coast. See The Wall Street Journal, April 6, 1966, p. 1, col. 6.

The buyer is in control of his business after he pays for his franchise (which is often tied to some kind of gadget or other tangible property). To some extent, therefore, he can directly defend his investment against operational risks. However, since the buyer is generally ill-informed about the mechanics of the franchised business, he is as susceptible as anyone to fraud in the franchising transaction. These considerations seem to have been at work in Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965), where the buyer was to be one of three stockholders of a corporation franchised for the operation of automatic archery lanes. The court did not apply the joint control theory, even though it appears that the buyer might well have exercised management control over the enterprise thereafter.

[132] SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

preme Court seems to require some additional element to establish seller responsibility for the transaction.

The requirement seems sound; securities regulation does not appear to be necessarily appropriate for all types of transactions in which the buyer's initial value is subjected to the risks of an enterprise. For example, the SEC has indicated that it would not *ordinarily* consider the term "security" to embrace trading stamps, streetcar tokens, meal tickets, Christmas gift certificates, box tops, or theater tickets.[133] Technically speaking, the initial value furnished by the buyer of such items is subjected to the risks of the seller's enterprise in much the same way as that of a creditor.[134] It is difficult to find any expectation of "profit" in these situations,[135] and perhaps this is why, under the teaching of *Howey*, they should not be classified as securities. Unfortunately, the analysis cannot be so simplistic. The SEC has indicated a willingness to take a second look at these transactions if they are "used as a method of corporate financing."[136] The reason for closer scrutiny would seem to be the increased degree of risk, since the expectation of "profits" would still be missing. This raises the question of whether a sufficiently high degree of risk will call the securities laws into operation, even in the absence of a reasonable expectation of profits.[137]

The same issue arises in the context of the so-called cooperative apartment arrangements, some of which have been excluded from the "security" category because of the lack of "profit" motive.[138] However, one may also ask whether there is any manifestation of risk to the buyer's initial investment. The buyer in these transactions often receives full rental value (usually a lease) in return for his initial investment.[139] If he occupies the leasehold, it cannot be

133 SEC Securities Act Release No. 3890, 1 CCH FED. SEC. L. REP. ¶ 1041 (Jan. 25, 1958).

134 See discussion of the creditor's risk at text accompanying notes 85-86 *supra*.

135 These devices have been described as "media created primarily for exchange." See Mundheim & Henderson, *Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans*, 29 LAW & CONTEMP. PROB. 795, 809 n.45 (1964).

136 SEC Securities Act Release No. 3890, 1 CCH FED. SEC. L. REP. ¶ 1041 (Jan. 25, 1958).

137 Extreme risk seems to be the only reasonable basis for the holding in Strauss v. State, 147 S.E.2d 367 (Ga. Ct. App. 1966) (money orders).

138 These transactions typically involve the buyer's transfer of property or a large initial sum of money to a corporation in exchange for a long-term lease of an apartment and stock in the corporation. At first blush, it certainly appears that the buyer assumes the same risks to his initial investment as any other percentage-share purchaser. See text accompanying notes 83-84 *supra*. But "no profit or income is generally anticipated." Op. Ariz. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70554 (Aug. 11, 1961).

139 "The substance of the purchase of such a share would amount to . . . securing a place to live . . . ." *Ibid.*

said that property received has been recommitted to use by an enterprise in the *Howey* sense.[140] It could be argued, with considerable force, that part of the initial value furnished for the apartment was paid in recognition of the future success of the apartment complex, *i.e.*, the fair market value of the apartment was probably ascertained by taking into account the anticipated but unrealized success of the apartment enterprise as a whole. Thus, the buyer's initial value would be subject to the risks of an enterprise in the sense of *SEC v. C. M. Joiner Leasing Corp.*[141] On the other hand, the apartment dwellers often exercise control in the affairs of the apartment complex, so that the joint control exception might apply.[142] In sum, it seems impossible to say unequivocally that the ground for excluding these arrangements from security classification is the lack of an expectation of "profits"; the crucial consideration may be the absence of risk.[143]

Thus, while it appears rather certain that the expectation of "profits" will not cause a transaction to be a security where the buyer has not furnished initial value which is in some way subjected to the risks of an enterprise,[144] it is difficult to say with certainty that a transaction involving a high degree of risk to initial investment, but lacking the expectation of profits, will not be called a security.[145]

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140 See text accompanying notes 87-101 *supra* for a discussion of transactions in which the buyer receives property (other than a creditor's claim or a proprietary interest) which has a fair market value equal to initial value but which is immediately recommitted to use by an enterprise.

141 320 U.S. 344 (1943). See text accompanying notes 102-10 *supra.*

142 Willmont v. Tellone, 137 So. 2d 610 (Fla. Dist. Ct. App. 1962). "The purpose of the corporation was to be purely incidental to the actual lease of the co-operative apartment—in other words, a vehicle by which control could be exercised." *Id.* at 612.

143 The California blue sky administrator has indicated that a cooperative apartment would be considered a security if the apartment complex were still in the developmental stages. On the reasoning of *Silver Hills*, part of the buyer's original value would then clearly be paid in recognition of the yet unrealized success of the entire complex. See Sobieski, *Securities Regulation in California: Recent Developments*, 11 U.C.L.A.L. REV. 1, 7-8 (1963). However, as we shall see, the *Silver Hills* fact pattern contains an element of expected profits, and so the analysis of that case does little to answer the question of whether risk to initial value, without reasonable expectation of profit, will support a security finding.

144 This would be the situation in which the buyer receives property which is not a proprietary interest or a creditor's claim, which is not recommitted for use by an enterprise, and which has a present fair market value (no part of which is determined by taking into account the anticipated but unaccomplished success of an enterprise) equal to the buyer's original investment.

145 *But see* Note, 14 HASTINGS L.J. 181 (1962): "[H]istorically the courts have firmly recognized that the investor must put up money or its equivalent for a share or

Nevertheless, two generalities may safely be stated about the relationship between risk to initial value and reasonable expectation of "profit": First, both factors are necessary in most security transactions. Second, as the degree of risk to initial value increases, the need for a well-defined "profit" motive lessens; *i.e.*, the elements of risk to initial value and reasonable expectation of profits are on a sliding scale of inverse proportionality. The preceding statements underscore the need for an accurate analysis of the various types of "profit."

(b) Species of "Profits."—Properly considered, "profits" refer to payments or distributions which may be either fixed[146] or variable[147] and either conditioned upon[148] or unrelated to[149] the

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stake in an enterprise or venture *with the expectation of* profit before his interest can be classified as a security." *Ibid.* (Footnotes omitted.)

146 Farrell v. United States, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964); United States v. Attaway, 211 F. Supp. 682, (W.D. La. 1962); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961) (fixed and variable); Donovan v. Dixon, 261 Minn. 455, 113 N.W.2d 432 (1962); State v. Davis, 131 N.W.2d 730 (N.D. 1964); Yoder v. So-Soft, Inc., 202 N.E.2d 329 (Ohio C.P. 1963).

147 Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); United States v. Schaefer, 299 F.2d 625 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962) (limited to ten times original investment); SEC v. Latta, 250 F. Supp. 170 (N.D. Cal.), *aff'd per curiam*, 356 F.2d 103 (9th Cir. 1965), *cert. denied*, 384 U.S. 940 (1966); Nicewarner v. Bleavins, 244 F. Supp. 261 (D. Colo. 1965); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964); Bellerue v. Business Files Institute, Inc., 61 Cal. 2d 488, 393 P.2d 401, 39 Cal. Rptr. 201 (1964); Smith v. Sherman, 206 Cal. App. 2d 93, 23 Cal. Rptr. 487 (Dist. Ct. App. 1962); Rivlin v. Levine, 195 Cal. App. 2d 13, 15 Cal. Rptr. 587 (Dist. Ct. App. 1961); People v. Woolson, 181 Cal. App. 2d 657, 5 Cal. Rptr. 766 (Dist. Ct. App. 1960); People v. Smith, 180 Cal. App. 2d 420, 4 Cal. Rptr. 282 (Dist. Ct. App. 1960).

Where property has been recommitted to an enterprise for management, there are several ways in which profits can be determined. For example, where the property being managed is productive, three possible situations may occur. First, the produce of each owner's property may be sold and the net profits accounted for separately. Second, the produce from all properties managed may be pooled for selling, with the net profits being divided in proportion to the produce derived from each owner's property. See SEC v. W. J. Howey Co., 328 U.S. 293 (1964); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir. 1953), *cert. denied*, 347 U.S. 925 (1954). The schemes for division of profits are not clear in some cases. See SEC v. Orange Grove Tracts, 210 F. Supp. 81 (D. Mass. 1962); SEC v. Bailey, 41 F. Supp. 647 (S.D. Fla. 1941). Third, the produce may be pooled for selling and the net profits divided in proportion to the quantity or value of each owner's property. Op. Fla. Att'y Gen. 3 BLUE SKY L. REP. ¶ 70653 (Dec. 14, 1964).

Where the managing enterprise has the power to sell the recommitted property, such property may be pooled for sale and the proceeds divided according to the ratio that the quantity of each owner's property bears to the total quantity of all propery sold. See SEC v. Great W. Land & Dev., Inc., CCH FED. SEC. L. REP. ¶ 91537 (D. Ariz. 1965) (Transfer Binder 1964-1966), *rev'd on other grounds and remanded*, 355 F.2d 918 (9th Cir. 1966); SEC v. Comstock Coin Co., CCH FED. SEC. L. REP. ¶ 91414 (D. Nev. 1964) (Transfer Binder 1964-1966); SEC v. Willoughy Coin Exch., CCH FED. SEC. L. REP. ¶ 91355 (S.D. Cal. 1964). On the other hand, each buyer's property may be sold and the proceeds accounted for separately. United States v. Herr, 338 F.2d 607 (7th Cir. 1964), *cert. denied*, 382 U.S. 999 (1966).

profits shown on the income statement of the risk enterprise. The reference point of profitability is the buyer. The important consideration here is whether the buyer has been led reasonably to expect some benefit over and above his initial investment, whether or not the inurement is conditioned upon the overall internal profitability of the risk enterprise.[150]

Must the benefit which the buyer is led to expect be in the nature of realized income? *SEC v. C. M. Joiner Leasing Corp.*[151] and *Roe v. United States*[152] tell us that it is sufficient if the buyer is led reasonably to believe that property which he receives will appreciate in value over and above his initial investment.[153] *Silver Hills Country Club v. Sobieski*[154] presents a somewhat more complicated problem. The buyer, in consideration of his initial value, received a membership in a then-unfinished country club, but he received no interest in the assets or profits of the club. It has been said that the "profit" which the buyer was led to expect was the future use of valuable club facilities.[155] On the facts of the case, this theory will not stand up, for the buyer was required to pay continuing monthly dues for the use of club facilities. It seems more accurate to say that the buyer purchased an intangible piece of property in the nature of an entrance privilege. The price paid for the entrance privilege was probably less than it would have been had the club

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[148] See authorities, except United States v. Schaefer, cited in the first paragraph of note 147 *supra*. See also Donovan v. Dixon, 261 Minn. 455, 113 N.W.2d 432 (1962).

[149] See authorities, except Donovan v. Dixon *supra* note 148, cited note 146 *supra* and in the second and third paragraphs of note 147 *supra*. See also United States v. Schaefer, 299 F.2d 625 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962); Yoder v. So-Soft, Inc., 202 N.E.2d 329 (Ohio C.P. 1963).

[150] The following consideration would seem to be irrelevant: "There is no reference to profits in the Advertising Commission Agreement. The Commission is payable . . . whether or not the company makes a profit on any particular sale or for any period of time." Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 3 BLUE SKY L. REP. ¶ 70631, at 66352 (Pa. C.P. 1963), *aff'd*, 414 Pa. 253, 199 A.2d 428 (1964). Unfortunately, the *Howey* formula did not specify to *whose* profits it referred. Upon close analysis, it appears clear that the court was not referring to the internal operating profits of the management enterprise to which the buyer's property had been recommitted.

[151] 320 U.S. 344 (1943).

[152] 287 F.2d 435 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).

[153] "A reasonably prudent-imprudent, prospective purchaser was certainly entitled to infer that the promised bonanza would come to him without any expenditure on his part." *Id.* at 438, n.4.

[154] 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961).

[155] "The purchaser, by buying a promotional membership, was risking his capital in the expectation that the potential benefits of a country club membership would materialize." Note, 50 CALIF. L. REV. 156, 158 (1962).

been completed. Thus, the buyer had reason to believe that his entrance privilege would appreciate in value.

The question remains, however, whether the buyer's expectation of valuable *non-pecuniary* benefits will fulfill the requirement for profit inducement. In a proper case, it seems that the *Silver Hills* rationale would be appropriate.[156]

And so it appears that the restrictive readings of the word "profits" in the *Howey* formula are unjustified.[157] It is sufficient if the seller is responsible for leading the buyer to believe that *some valuable benefit*, over and above his initial investment, will accrue as a result of the operations of an enterprise.

(c) The "Speculation" Red Herring.—Before leaving this analysis of the essential characteristics of a security, it is well to note that "speculation" is not such a characteristic.[158] Risk to initial value is a prerequisite, but the degree of risk need not be so high as to make the investment "speculative."[159]

E. *The Desirability of a Pervasive Definition*

As already noted, the definition sections of the federal and many state securities statutes contain a list of rather specific devices and arrangements,[160] plus a group of general classifications which have no readily identifiable content.[161] In cases where the form of the alleged security transaction does not come within the literal coverage of the specific definitional categories, the courts and agencies, in the process of applying the general statutory language, have been forced to evolve statements of the essential characteristics of a

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156 For example, an enterprise, still in the initial promotional stages, sells coupons entitling the buyers to goods or services having a fair market value greater than the initial value furnished.

157 See, *e.g.*, Pennsylvania Sec. Comm'n v. Consumers Research Consultants, Inc., 3 BLUE SKY L. REP. ¶ 70631 (Pa. C.P. 1963), *aff'd*, 414 Pa. 253, 199 A.2d 428 (1964); Emery v. So-Soft, Inc., 199 N.E.2d 120 (Ohio Ct. App. 1964).

158 "We reject the suggestion . . . that . . . [a security] is necessarily missing where the enterprise is not speculative . . . ." SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946). Similarly, "the term 'speculation' does not signal automatic subjection to corporate securities regulation." Sarmento v. Arbax Packing Co., 231 Cal. App. 2d 421, 424, 41 Cal. Rptr. 869, 871 (Dist. Ct. App. 1964).

159 Thus, the following statement appears to be somewhat misleading: "The important facts here are the speculative nature of the interest sold and its size." Nicewarner v. Bleavins, 244 F. Supp. 261, 265 (D. Colo. 1965).

160 *E.g.*, "any note, stock . . . bond . . . evidence of indebtedness." Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1964).

161 *E.g.*, "certificate of interest or participation in any profit-sharing agreement . . . transferable share, investment contract . . . or, in general, any interest or instrument commonly known as a security." *Ibid.*

security.[162] However, even though the tests for identifying a security have been developed in the context of the general definitional classifications, there is no reason why such tests should not pervade the entire section. If the security formula and its underlying analysis[163] accurately describe the essential economic factors which create a need for the fundamental fraud protections of the securities laws, then presumably they should be controlling even where the form of the transaction comes within the literal coverage of the definition section. This approach has been suggested by the courts[164] and urged by the commentators.[165]

The precise issue here is whether, in the absence of one or more of the essential economic characteristics of a security, a transaction should nonetheless be classified as a security simply because it fits into one of the readily identifiable pigeonholes of the definition statute.[166] It has already been noted that some adjudicators are wont to exclude transactions from the literal coverage of the definition provisions where the buyer exercises some management control over the risk enterprise[167] and where the elements of risk to initial value

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162 *E.g.*, SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943); Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 809, *cert. denied*, 382 U.S. 903 (1965).

163 See text accompanying notes 47-159 *supra*.

164 Recall the general mandate of *Howey* that "form [is] . . . disregarded for substance and emphasis [is] . . . placed upon economic reality." 328 U.S. at 298. See Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961), wherein the following rule of interpretation was announced: "[The transaction] . . . qualifies . . . [as a security] within the literal language of the [statute] . . . . The crucial question nevertheless remains whether the sale of such a membership comes within the regulatory purpose of the . . . Securities Act." *Id.* at 814, 361 P.2d at 908, 13 Cal. Rptr. at 188.

In People v. Davenport, 13 Cal. 2d 681, 91 P.2d 892 (1939), the court stated:

> [W]ords . . . may be given a contracted meaning dependent upon the connection in which they are employed, and considering the general purpose or scheme entertained by the legislature . . . and the rule that words will not be given their literal meaning when to do so would evidently carry the operation of the enactment far beyond the legislative intent . . . [make it] clear that the legislature intended by use of the words . . . in [the definition section] . . . such as 'note' and 'evidence of indebtedness,' that each such expression should possess the same general characteristics as the word 'security' . . . . *Id.* at 685-86, 91 P.2d at 895.

165 "This doctrine of 'substance-over-form' . . . should be, and apparently is available for purposes of definitional exclusion as well as inclusion." Pasquesi, *The Expanding "Securities" Concept*, 49 ILL. B.J. 728, 732 (1961).

166 The question of whether certain transactions ought to be excluded from the coverage of the securities laws even though *all* the essential economic characteristics of a security are present will be discussed in text accompanying notes 184-204 *infra*.

167 See authorities cited note 123 *supra*. Hargiss v. Royal Air Properties, Inc., 206 Cal. App. 2d 406, 23 Cal. Rptr. 678 (Dist. Ct. App. 1962) (involving both stock and notes).

or reasonable expectation of profits are lacking.[168] However, in some cases, where the transactions at issue possessed all the characteristics of a security and could have been classified as securities on the basis of an "economic realities" analysis, the courts have evinced a tendency to reach cursory results based simply on literal coverage.[169] There are at least two spurious considerations which have led some courts to forego full analysis of transactions which appear to be securities *in form.*

(1) "Handy Latin Aphorisms": The Ejusdem Generis Carousel.—The misty maxims of statutory construction are often double-edged swords. In *SEC v. C. M. Joiner Leasing Corp.*,[170] the form of the transaction at bar did not come within one of the specific categories of the definition statute. The defendant claimed, therefore, that the general classifications of the definition (*e.g.*, "investment contract" or "any interest or instrument commonly known as a 'security' ") must be limited by the specific categories (*e.g.*, "stock" and "bond"). But Mr. Justice Jackson chose to "construe the details of . . . [the] act in conformity with its dominating general purpose, . . . [reading] text in the light of context."[171] As the Fifth Circuit later commented, *Joiner* has "rejected any construction of the Act on the basis of handy Latin aphorisms."[172]

In a subsequent case, however, where the alleged "security" transaction was a "note" and thus came within the literal coverage

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168 *E.g.*, trading stamps, theater tickets, etc. SEC Securities Act Release No. 3890, 1 CCH FED. SEC. L. REP. ¶ 1041 (Jan. 25, 1958).

These are certainly "evidences of indebtedness." The cooperative apartment transactions (involving corporate stock) are also illustrative of the practice of analyzing a transaction for its security aspects even though it appears prima facie to be within the literal coverage of the statute. See text accompanying notes 138-43 *supra. E.g.*, Willmont v. Tellone, 137 So. 2d 610 (Fla. Dist. Ct. App. 1962) (stock).

169 See Farrell v. United States, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964) (mortgage notes). "Appellants complain that the instruction [to the jury] fails to define the terms 'any note' or 'evidence of indebtedness' appearing in [Securities Act § 2(1), 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1964)] . . . . In our view such ordinary terms are self-defined and require no further definition." Farrell v. United States, *supra* at 417. See Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); United States v. Monjar, 47 F. Supp. 421, 427 (D. Del. 1942), *aff'd*, 147 F.2d 916 (3d Cir. 1944) ("receipts [for personal loans] certainly fall within the category of an 'evidence of indebtedness' "); Whitlow & Associates v. Intermountain Brokers, Inc., CCH FED. SEC. L. REP. ¶ 91800 (D. Hawaii, March 25, 1966) (Transfer Binder 1964-1966); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961); State v. Davis, 131 N.W.2d 730 (N.D. 1964).

170 320 U.S. 344 (1943).

171 *Id.* at 350-51.

172 Roe v. United States, 287 F.2d 435, 437 (5th Cir.), *cert. denied*, 368 U.S. 824 (1961).

of the definition section,[173] the defendant claimed that the specific categories should be limited, when necessary, by the generic notions which had been developed under the amorphic phraseology of the statute (*e.g.*, "transferable share," "investment contract," or "any commonly known as a security").[174] The court, noting that the *ejusdem generis* argument had already been judicially rejected, stated summarily: "This instrument is clearly an 'evidence of indebtedness,' and as such falls within the statutory definition of securities."[175]

The foregoing illustrates the futility of talking in terms of aphoristic rules of construction. They are simply "anodynes for the pains of reasoning." *Joiner* rejected one interpretative approach because it seemed inappropriate. *Llanos v. United States*[176] summarily rejected a seemingly proper method of construction because it was based on an *ejusdem generis* argument.[177]

(2) A Liberal-Formal Construction: The Double Threat.—Although Mr. Justice Jackson expressly opted in *Joiner* to perform the task of statutory interpretation unencumbered by rules of liberality or strictness, it has been the overwhelming consensus of the recent opinions that the securities laws are to be liberally construed. While this approach is normally harmless, there is one instance in which it can have pernicious effects. As has already been seen, some courts are inclined to the view that all transactions falling within the specific categories of the definition sections are conclusively securities, without the need for further inquiry to determine whether they possess the economic characteristics which would create a need for the application of the securities laws.[178] If such courts also adopt a practice of liberally defining the terms "stock," "bond," "note," or "evidence of indebtedness," any examination of "economic realities" might well be foreclosed with respect to the majority of alleged "security" transactions.[179]

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173 Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954).

174 See generally Securities Act § 2, 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b (1964).

175 Llanos v. United States, 206 F.2d 852, 854 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954).

176 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954).

177 Fortunately, the court would have probably reached the same result if it had pursued the interpretative approach suggested by the defendant.

178 *E.g.*, Commonwealth *ex rel.* Pa. Sec. Comm'n v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964).

179 This radical approach might have been responsible for the puzzling result in Strauss v. State, 147 S.E.2d 367 (Ga. Ct. App. 1966), wherein money orders were held to be securities simply because they were "evidences of indebtedness." *Id.* at 370.

(3) Prognosis.—So far, and fortunately, few questionable decisions have resulted from a failure to apply the "economic realities" test to transactions which come within the literal meaning of the specific definitional categories.[180] Moreover, the cases which have faced the issue squarely have given the "economic realities" test primacy over literal coverage.[181] On the merits, this is the most desirable approach. If the formula and its underlying analysis properly delineate the essential elements of the "security" concept, it should be applied pervasively. By use of the introductory phrase "unless the context otherwise requires,"[182] the present definitional provisions seem to sanction the use of an overriding test for identifying a security. On the other hand, if future decisions follow a pattern of making literal coverage determinative of security status without further inquiry, the definition sections of the securities laws should probably be amended to provide expressly that satisfaction of the literal or formal aspects of the statute are not conclusive of its applicability.[183]

F. The Isolated and Private Transaction

As the final topic of this article, the thorny problem of determining the proper analysis and treatment for isolated and private transactions, such as loan or purchase money notes and the small offering of limited partnership interests, will be discussed. The word "isolated" will be used to refer to the limited number of transactions, and the term "private" will describe the buyers' financial sophistication or their knowledge of the risk enterprise.

First, it should be noted that the transactions now under consideration ordinarily possess, to some degree, all the essential economic characteristics of a security which were previously elaborated. Of course, it may happen that the buyer, in addition to being familiar with the operations of the risk enterprise (so that the transaction is "private"), may also play an active management role. In such a case, one of the essential economic elements of a security would be missing, and the "joint control" doctrine would apply.[184]

180 As already noted, most of the cases which have taken the ultra-literal approach would, coincidentally, have reached the same result by applying the "economic realities" test.

181 See authorities cited note 164 *supra*.

182 *E.g.*, Securities Act § 2, 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b (1964).

183 Such a statute might first state the general and controlling test for a security in terms of the "economic realities" formula. The categories in the present statute might then be described as being prima facie or presumptively securities.

184 See text accompanying notes 123-31 *supra*.

What should be the result if the control prerogative is lacking? The question will be viewed first in the light of the present statutory structure.

(1) Implications of the Statutory Scheme.—One has the feeling that the special fraud protection of the securities laws should not be applicable to the huge number of isolated transactions in which the buyers are financially sophisticated and familiar with the operations of the risk enterprise. However, as the statutes are presently written, the isolated nature of a transaction and the element of privateness are generally relevant only to the issue of whether a transaction should be exempt from registration or state administrative approval. If a transaction is isolated and private, the danger of fraud is reduced both quantitatively and qualitatively; in other words, these elements are factors which mitigate, but do not eliminate, the probability of fraud. In the federal context, sections 3 and 4(2) of the Securities Act[185] deal with such mitigating factors, but neither section exempts a transaction from the anti-fraud provisions of sections 12(2) and 17(a).[186]

In the case of a promissory note, there is a further complication arising from the introductory language of section 3(a).[187] The statute exempts various "classes of securities" from registration under circumstances where the likelihood of fraud is substantially mitigated. One of the classes listed is "any note" having certain characteristics which increase the probability that it will be circulated among sophisticated or knowledgeable buyers. Thus, by the express language of section 3(a), there is a further statutory indication that notes are "classes of securities" even though they are issued under circumstances which greatly reduce the chances of fraud being practiced upon the buyer.[188] Stated differently, section 3(a) furnishes additional support for the proposition that factors in mitigation of the probability of fraud are relevant to the issue of exemption — not to the issue of security status. This inference is

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185 48 Stat. 75, 77 (1933), as amended, 15 U.S.C. §§ 77c, 77d(2) (1964).

186 In the state context, UNIFORM SECURITIES ACT § 402, 1 BLUE SKY L. REP. ¶ 4932 (1958) does not exempt transactions from the anti-fraud provisions of §§ 101 and 410(a)(2), 1 BLUE SKY L. REP. ¶¶ 4902, 4940 (1958).

187 See also UNIFORM SECURITIES ACT § 402(a), 1 BLUE SKY L. REP. ¶ 4932 (1958).

188 This argument has been made with respect to the California securities law. "The exemption gives recognition to partnership interests . . . as securities. The [exemption] statute, in fact, expressly calls such interests securities. They are merely exempted under certain conditions . . . ." Jahn, *When Is a Security a Security?*, 40 LOS ANGELES B. BULL. 75, 77 (1964). *But cf.* authorities cited note 195 *infra.*

strengthened by the fact that Congress *did* exclude certain "notes" from the *definition* of "security" in the Securities Exchange Act.[189]

Securities Exchange Act Rule 3a11-1[190] is also relevant. By its provisions, "limited partnership" interests are included without qualification in the "equity security" category. The language of the rule certainly cuts against the view that the isolated and private nature of such interests might result in their escaping "security" classification.[191]

In summary, there seems to be little statutory justification for excluding a transaction from "security" classification solely because of its isolated and private nature. Still, for purposes of subsequent discussion, it should be remembered that the danger of fraud is qualitatively reduced if the transaction is private (involving buyers who are financially sophisticated or who have knowledge of the risk enterprise) and quantitatively reduced if the transaction is isolated (involving only a few buyers).

(2) The "Cut-Off" Consideration.—Although the present statutes may tend to indicate that a transaction should not escape security classification just because it is isolated and private, it may be argued that Congress and the state legislatures did not intend the special fraud procedures, protections, and remedies of the securities laws to be applicable to every isolated and private purchase money note or limited partnership interest. The policy of the argument would probably be one of judicial and administrative economy. The SEC, state agencies, and the courts should not have to resort to the special anti-fraud machinery of the securities laws every time ABC Corp. and John Doe issue a purchase money note. In other words, there should be a point at which the applicability of all the provi-

189 "The term 'security' . . . shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months . . . ." Exchange Act § 3(a)(10), 48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(10) (1964).

190 17 C.F.R. § 240.3a11-1 (Supp. 1966). Presumably an "equity security" is basically a "security." See Exchange Act § 3(a)(11), 48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(11) (1964).

191 See 1 LOSS, SECURITIES REGULATION 504-05 (2d ed. 1961), where it is suggested that an isolated and private offering of interests in a limited partnership formed under the Limited Partnership Act might not be considered an offering of securities. However, it should be noted that, although a limited partner must consent to the substitution of new partners, he must also remain passive with respect to the management of the enterprise. The joint control exception would therefore seem unavailable. Moreover, the troublesome characteristics of risk to initial investment and expectation of profits are clearly present. When the foregoing considerations are coupled with the implications of the statutory structure, it is difficult to find much support for the suggestion that an isolated and private offering of limited partnership interests should not be deemed to involve the sale of securities. But, then, *quandoque bonus dormitat Homerus.*

sions of the securities laws is "cut off," even when the economic realities of a security are present. Such an argument seems hard to digest simply on the ground that Congress and the state legislatures did not intend to be picayune. However, the argument gains some strength and perhaps tips the scales when it is thrown into the balance with the previous suggestion that the danger of fraud is reduced both qualitatively and quantitatively if a transaction is isolated and private.

(3) The Decisions.—Even if it be assumed that an isolated and private note is not a security at the time of its making, such a note may later become a security if it is bought up and distributed to the public.[192] Similarly, loan or purchase money notes of an individual[193] or a corporation[194] may constitute securities when they are offered to the public by the makers.

There is some judicial authority which would support the view that an isolated and private note is not a security at the time of its issuance.[195] On the other hand, it must be remembered that the term "note" is one of the specific predicaments of the definition provisions,[196] and, as already observed, some courts show a marked tendency to make literal coverage determinative on the issue of "security" status.[197]

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192 Farrell v. United States, 321 F.2d 409 (9th Cir. 1963), *cert. denied*, 375 U.S. 992 (1964); Op. Cal. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70239 (Aug. 25, 1954); Op. Mich. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70360 (Oct. 29, 1957).

193 Llanos v. United States, 206 F.2d 852 (9th Cir. 1953), *cert. denied*, 346 U.S. 923 (1954); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961); United States v. Monjar, 47 F. Supp. 421 (D. Del. 1942), *aff'd*, 147 F.2d 916 (3d Cir. 1944).

194 People v. Leach, 290 Pac. 131 (Cal. Dist. Ct. App. 1930), *appeal dismissed*, 283 U.S. 808 (1931); State v. Davis, 131 N.W.2d 730 (N.D. 1964).

195 *Cf.* Cecil B. DeMille Prods., Inc. v. Woolery, 61 F.2d 45 (9th Cir. 1932); People v. Davenport, 13 Cal. 2d 681, 91 P.2d 892 (1939); Nicholl v. Ipsen, 278 P.2d 927 (Cal. Ct. App. 1955); People v. Leach, *supra* note 194 (dictum). In California, there is an exemption for notes not offered to the public. CAL. CORP. CODE § 25102(c). Nonetheless, the language of the cases seems to go beyond the exemption and to imply that private and isolated loan and purchase money notes are not really securities at all.

196 Recall, however, that the definition section of the Exchange Act excludes certain "notes." Exchange Act § 3(a)(10), 48 Stat. 884 (1934), 15 U.S.C. § 78c(a)(10) (1964).

197 See authorities cited notes 169, 179 *supra*. In a rather elliptically written opinion, the district of Hawaii has come as close as any court to holding that a private and isolated note is a security. See Whitlow & Associates v. Intermountain Brokers, Inc., CCH FED. SEC. L. REP. ¶ 91800 (D. Hawaii, March 25, 1966) (Transfer Binder 1964-1966). The ultra-literal approach is dominant, with no discussion of the possible distinctions arising from the fact that only one note was involved and was to be issued to a buyer who appeared to be fully informed and financially sophisticated.

In the absence of facts supporting a finding of "joint control,"[198] recent opinions evidence a willingness to classify limited partnership interests as securities,[199] even when the offerings seem rather isolated and private.[200]

(4) Summary.—Unless the buyer actively participates in the control of the issuer's activities, it seems that there is virtually no statutory support for,[201] and only slim judicial recognition of, the view that notes and limited partnership interests should be excluded from the "security" category simply because they are isolated and private transactions.[202] Nonetheless, if it be recognized that the danger of fraud is quantitatively and qualitatively reduced where a transaction is both isolated and private, there is persuasive force in the argument that the application of the special fraud procedures, protections, and remedies of the securities laws should be cut off short of the thousands of transactions which involve only a handful of knowledgeable or sophisticated buyers.

In any event, if it were decided that transactions which are both isolated and private should be excluded from the definition of "security," such a result could be assured only by an amendment of the definition provisions.[203] One result of such an amendment would be to exclude entirely from the coverage of the securities laws some of those transactions which are currently exempted only from registration or administrative approval. A second result would be that the "joint control" exception would be partly subsumed by the definitional exclusion.[204]

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198 Such a case would be highly unlikely in the context of a true limited partnership, since the passive partners lose their limited liability status if they so much as poke their noses in management's door.

199 Conroy v. Schultz, 194 A.2d 20 (N.J. Super. Ct. 1963) (public offering).

200 Op. Nev. Att'y Gen., 3 BLUE SKY L. REP. ¶ 70691 (Nov. 12, 1965) (twenty-four interests).

201 The words, "unless the context otherwise requires," (*e.g.*, at the beginning of Securities Act § 2, 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b (1964)) seem to be eclipsed by the other inferences to be drawn from the statutory structure.

202 A recent opinion seems to hold the contrary. Whitlow & Associates v. Intermountain Brokers, Inc., CCH FED. SEC. L. REP. ¶ 91800 (D. Hawaii, March 25, 1966) (Transfer Binder 1964-1966).

203 The "economic realities" formula could be modified as indicated in note 47 *supra.*

204 The requirements under the present doctrine would seem to be at least (1) familiarity with the risk enterprise at the time of the alleged security transaction, and (2) the right to actively participate in the management of the enterprise thereafter. Under an "isolated and private" exclusion, familiarity with the enterprise alone would suffice if the transaction were truly isolated, *i.e.*, involved few enough offerees.

III. CONCLUSION

What is a "security"? This simple question has assumed major proportions in light of the judicial and administrative trend towards including many different types of transactions within the statutory definition. The issue is all the more important in view of the expanding jurisdictional base of the federal statutes and the increased number of statutory remedies being successfully employed by securities purchasers.[205]

The subjection of the buyer's initial value to the risks of an enterprise with which he is not familiar and over which he exercises no control seems to be the "economic reality" which most clearly creates a need for the special fraud procedures, protections, and remedies of the securities laws. There are several manifestations of risk, some of which are difficult to discern, and therefore each transaction must be carefully analyzed to make certain that the risk factor has been accurately appraised.

In general, it is also necessary that the seller be responsible for leading the buyer reasonably to expect some valuable benefits over and above initial investment. Here again, it must be recognized that there are several different species of valuable benefit.

Formulas can only serve as guidelines for reasoning. Accordingly, this article has set forth what is thought to be an accurate shorthand test for identifying a security and a pattern of analysis which should aid the process of isolating each of the "economic realities" of a security.

Once the essential characteristics of a security have been accurately identified and stated in the form of an analytical test, it is only reasonable that such test should be controlling, even where the form of a particular transaction comes within the literal coverage of the definition provisions of the securities laws. If courts do not follow this approach, it should be legislatively adopted by amending the definition provisions.

On balance, there seems to be persuasive merit in the suggestion

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205 Suppose *S* sells vacuum cleaners at an over-charge and promises to pay the buyers a portion of the profits made on future referral sales. Assume also that such a transaction is held to be a "certificate of interest or participation in [a] profit sharing agreement." See SEC Rule 3a11-1, 17 C.F.R. § 240. 3a11-1 (Supp. 1966). If enough sales are made and the seller has "total assets" exceeding one million dollars, registration of these arrangements under the Exchange Act might be required. See Exchange Act § 12(g), 48 Stat. 892 (1934), as amended, 15 U.S.C. § 78*l*(g) (1964).

that isolated *and* private transactions should be excluded from security classification, even though all the economic realities of a security may be otherwise present. However, the present statutory structure gives rise to a clear inference that the isolated or private nature of a transaction is relevant to the issue of exemption and not to the question of security status. Therefore, if isolated and private transactions are not to be considered securities, amendments will be in order.